DOCUMENT RESUME

ED 438 615 EA 030 255

TITLE	A Management Review of Commonwealth Charter Schools.
INSTITUTION	Massachusetts State Office of the Inspector General, Boston.
REPORT NO	Pub-18259-170-5C-11/99-IGO
PUB DATE	1999-11-00
NOTE	165p.
PUB TYPE	Reports - Evaluative (142)
EDRS PRICE	MF01/PC07 Plus Postage.
DESCRIPTORS	*Business Administration; *Charter Schools; Educational Administration; *Educational Assessment; Elementary Secondary Education; Operating Expenses; School Demography; State Surveys; *Summative Evaluation
IDENTIFIERS	*Massachusetts

ABSTRACT

This report focuses on the business operations of 24 charter schools in Massachusetts. The legislation authorizing the establishment of public charter-school in Massachusetts stipulated that a study of these schools' operations, practices, and activities must be conducted. The information gathered in the review came from the Massachusetts Department of Education (DOE), charter- school records, and interviews with officials of the DOE's charter-school office. To date, charter-school business operations have received little scrutiny, with the bulk of assessment being directed at educational effectiveness. The 24 schools in this review were granted charters between 1994 and 1996, and consisted of seven elementary schools, five combined elementary-middle schools, five middle schools, six high schools, and one school serving students in K-12. The report's 17 central findings highlight weaknesses that could undermine charter schools' ability to achieve their educational objectives. These are in the areas of contracting practices, internal controls, and procurement procedures. The report's recommendations are aimed at strengthening the Massachusetts charter-school initiative, increasing charter-school accountability, and protecting the public's investment in charter schools. The analysis focuses on contracts with private management contractors, conflict of interest, loans, financial management and oversight, procurement procedures, and facility leasing. Two appendices contain the DOE's response and a list of 26 resources. (RJM)

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Office of the Inspector General

Commonwealth of Massachusetts

ED 438 615

A Management Review of Commonwealth Charter Schools

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Robert A. Cerasoli
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November 1999

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November 1999

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The Honorable Speaker of the House of Representatives

The Honorable Chairman of the Senate Ways and Means Committee

The Honorable Chairman of the House Ways and Means Committee

The Honorable Chairman of the Senate Post Audit and Oversight Committee

The Honorable Chairman of the House Post Audit and Oversight Committee

The Directors of the Legislative Post Audit Committees

The Secretary of Administration and Finance

Members of the General Court

Omnibus ad quos praesentes literae pervenerint, salutem.

I am today releasing a report concerning charter schools in Massachusetts. At the direction of the Legislature, my Office reviewed the business operations of 24 Commonwealth charter schools. This report identifies weaknesses in the contracting, procurement, and financial management of some of these schools. Left uncorrected, these weaknesses are likely to undermine the schools' capacity to achieve their educational objectives and could jeopardize the interests of state taxpayers whose dollars fund charter schools. Accordingly, the recommendations provided in this report are aimed at improving charter school business policies and practices through best value contracting and proactive oversight by the Department of Education (DOE).

Since the inception of the Massachusetts charter school initiative in 1993, charter school business operations have received little scrutiny, either in Massachusetts or elsewhere in the nation. Sound, cost-effective business practices are essential to any organization. It is my hope that this report, by focusing attention on the need for improved business practices, will increase the likelihood that charter schools will succeed.

The DOE recognizes the need to broaden and strengthen its oversight of charter school business operations through both technical assistance and effective monitoring, and has already begun to do so. My Office stands ready to provide assistance to the DOE in implementing the recommendations provided in this report. I appreciate the cooperation provided to my Office by the DOE as well as by the charter schools in this review.

Sincerely,

Robert A. Cerasoli

Robert A. Cerasoli
Inspector General

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Publication No.18259-170-5C-11/99-IGO, approved by Philmore Anderson III, State Purchasing Agent.
Printed on recycled paper.

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Executive Summary

INTRODUCTION

Legislation authorizing the establishment of public charter schools in Massachusetts was enacted in 1993 as Massachusetts General Laws Chapter 71, Section 89 and subsequently amended in 1995, 1996, 1997, and 1998. Chapter 46 of the Acts of 1997, which amended the charter school law, directed the Office of the Inspector General to conduct a study of operations, practices, and activities at the established charter schools in the Commonwealth. In conducting this review, the Office reviewed records obtained from the Department of Education (DOE) as well as from the 24 charter schools in the scope of this review. The Office also conducted interviews with officials of the DOE's charter school office. The Office appreciates the DOE's assistance and cooperation during the course of this review.

This report focuses on the business operations of the 24 charter schools in this review. The report findings highlight weaknesses that could undermine charter schools' ability to achieve their educational objectives and jeopardize the interests of state taxpayers, whose dollars fund charter schools. The report recommendations are aimed at strengthening the Massachusetts charter school initiative, increasing charter school accountability, and protecting the public's investment in charter schools.

Background on Charter Schools

Charter schools represent one facet of a national reform movement that has promoted and engendered innovative public education approaches and organizational arrangements in many states, including Massachusetts. Charter schools are generally free to establish their own curricula, hire their own staff, and control their own finances. In return, charter schools are expected and obligated to fulfill the objectives of their charters. An underlying premise of the charter school concept is that introducing competition into the public education system will have beneficial effects.

Massachusetts was one of the first five states in the country to undertake a charter school initiative. The charter school law authorizes the creation of two types of charter schools: Commonwealth charter schools and Horace Mann charter schools. When the Office initiated this review in March 1998, no Horace Mann charter schools had been established; accordingly, no Horace Mann charter schools were included in the scope of this review. Thus, the findings contained in this report relate exclusively to Commonwealth charter schools.

Commonwealth charter schools receive state funds under M.G.L. c. 70, which establishes standards for state funding of public schools in Massachusetts. According to the DOE's published statistics, charter schools in Massachusetts received close to $45 million in M.G.L. c. 70 funds in the 1998 fiscal year. In addition, charter schools, like other public schools, may receive federal and state grant funds. Under the charter school law, charter schools may incur temporary debt in anticipation of receiving funds, provided that the terms of repayment may not exceed the duration of the school's charter without the approval of the Board of Education. Charter schools may also receive funds and other donations from private donors.

The charter school initiative, both nationally and in Massachusetts, is designed to require performance-based accountability. In Massachusetts, the determination of whether a charter school should receive public funds is guided by three questions:

1. Is the academic program a success?
2. Is the school a viable organization?
3. Is the school faithful to the terms of its charter?

A charter school office within the DOE is responsible for overseeing and providing technical assistance to Massachusetts charter schools. The responsibilities of the DOE's charter school office include, but are not limited to, evaluating new charter applicants; assisting newly chartered schools; monitoring the performance of charter schools in improving the academic performance of charter school students; reviewing charter school reports; disbursing state aid to charter schools; and evaluating renewal

applications. Since February 1999, these functions have been carried out by two professional staff.

Profiles of Charter Schools in This Review

The 24 schools in this review were granted charters between 1994 and 1996. In 1998, these schools consisted of seven elementary schools, five combined elementary-middle schools, five middle schools, six high schools, and one school serving students in kindergarten through twelfth grade. In the 1998 fiscal year, the 24 schools received state aid under M.G.L. c. 70 totaling $44,302,722 for a combined enrollment of 6,590 students. The expenditures reported by the 24 schools totaled $49,902,034 in the 1998 fiscal year.

Contracts with Private Management Contractors

Under the charter school law, charter schools are authorized to procure services, equipment, and supplies under contracts and leases with private vendors. The Board of Education is required to approve the terms of any contract with a private entity that will provide "substantially all educational services" to the school. This report refers to the private entities providing these educational and administrative services to charter schools as "management contractors."

The Office's review disclosed that some contracts between charter schools and their management contractors contained provisions that could undermine the schools' ability to achieve their educational objectives. These provisions also jeopardized the interests of state taxpayers whose dollars fund those schools.

Finding 1. Four management contracts for educational services contained no contractor performance requirements measuring students' academic achievement.

Finding 2. **Management contracts executed by some charter schools contained compensation provisions that posed unwarranted risks to the charter schools and taxpayers.**

- **Two contracts based the management contractor's compensation on the school's surplus revenues.**
- **Two contracts based the management contractor's compensation on a percentage of school expenses.**
- **Three contracts did not accurately reflect the actual compensation arrangements between the schools and their management contractors.**

Finding 3. **Management contracts executed by five charter schools contained provisions that could restrict public use of educational curricula and other intellectual property developed with public funds.**

Finding 4. **The DOE's management contract approval process has been unsystematic and inconsistently implemented.**

Conflict of Interest Issues

Charter schools are subject to the Massachusetts conflict of interest law, M.G.L. c. 268A, which regulates the conduct of public officials and employees at all levels of government in Massachusetts. The purpose of the conflict of interest law is to ensure that public officials' financial interests and personal relationships do not conflict with their public obligations. Under the charter school law, charter schools are deemed state agencies for the purposes of M.G.L. c. 268A. Any individual who holds an office, position, or employment with a charter school, whether paid, unpaid, full-time, or part-time, is considered a state employee under the conflict of interest law. Individuals serving as consultants to charter schools are also covered by the law in most cases.

Elected and certain appointed state officials are required under M.G.L. c. 268B, the financial disclosure law, to file annual statements of financial interest reporting their financial activities of the previous year, including their income, business ownership and equity, real property owned in Massachusetts, securities and investments, and certain information pertaining to their family members, with the State Ethics Commission. Until 1998, the charter school law required members of the boards of trustees of all charter

schools to file statements of financial interest pursuant to M.G.L. c. 268B, §5. However, in April 1998 the charter school law was amended to require a more abbreviated annual financial disclosure requirement for charter school trustees.

Under the charter school law, the members of a charter school's board of trustees are "public agents authorized by the commonwealth to supervise and control the charter school." As board members, charter school trustees are required to fulfill certain fiduciary obligations or duties that apply to members of all boards of directors, whether their organizations are private or public. These duties are generally referred to as the "duty of care" (sometimes called the duty to be informed) and the "duty of loyalty."

DOE records showed that as of May 1999, 308 trustees – virtually all trustees of the 24 charter schools in this review – had complied with the annual financial disclosure requirement contained in the charter school law. Of these, approximately three-quarters disclosed no financial interests in any charter schools.

M.G.L. c. 268A, §6 prohibits a state employee from participating in an official capacity in any particular matter that would affect the financial interest of a business organization in which the employee is serving as officer, director, trustee, partner, or employee unless the employee receives permission from the public official who appointed the employee to his or her job. The information reported on the disclosure forms showed that some charter school trustees had financial interests that required them to restrict their actions as trustees in order to comply with the conflict of interest law and their duty of loyalty to their charter schools. For example, 29 trustees reported that they were also employed by their schools as teachers or administrators. Under the charter school law, the Commissioner of Education is the appointing official of members of charter school boards of trustees for purposes of M.G.L. c. 268A, the conflict of interest law. As of May 1999, DOE records contained no disclosures from charter school trustees pursuant to M.G.L. c. 268A, §6, or written determinations by the DOE in response to such disclosures. In interviews, DOE officials confirmed that the DOE had not granted written permission to any charter school trustees to participate in particular matters in which they held financial interests.

Finding 5. **The composition of some charter school boards of trustees could undermine the boards' ability to fulfill their fiduciary duties to the schools they serve.**

Finding 6. **The DOE has provided no guidance to charter schools concerning the requirements of the conflict of interest law.**

Loans

Most public schools in Massachusetts are subject to stringent borrowing rules. Charter schools are not subject to these borrowing restrictions. Under the charter school law, charter schools may incur temporary debt in anticipation of receiving funds, provided that the terms of repayment may not exceed the duration of the charter without the approval of the Board of Education. There are no restrictions on the purposes for which charter schools may borrow funds or the amount of funds charter schools may borrow, nor are the terms of charter school loans subject to any specific approval or disclosure requirements.

According to the charter schools' audited financial statements, a total of 10 of the 24 schools had outstanding loans and other financial obligations – such as overdue fees and interest charges owed to management contractors – at the close of the 1998 fiscal year. The total outstanding balances included approximately $12.3 million owed by Boston Renaissance Charter School, approximately $6 million owed by Seven Hills Charter School, and smaller amounts owed by Boston University Residential Charter School, Cape Cod Charter School, Hilltown Cooperative Charter School, Lynn Community Charter School, Neighborhood House Charter School, SABIS International Charter School, Somerville Charter School, and South Shore Charter School.

Finding 7. **Loan agreements between charter schools and their management contractors could render the schools excessively dependent on their management contractors while reducing the schools' contracting leverage.**

Finding 8. State taxpayers could be liable for unpaid debts of charter schools that lose their charters.

Financial Management and Oversight

The Massachusetts charter school initiative has defined three performance measures by which charter schools are to be evaluated and held accountable: academic program success, organizational viability, and adherence to the school charter. Financial management is a key component of a charter school's organizational viability.

The DOE's charter school regulations require a charter school applicant to demonstrate its ability to achieve fiscal and operational viability within the five-year charter term in order to obtain charter approval. The Board of Education may revoke a charter for financial insolvency. DOE regulations also require a charter school seeking renewal of its charter to demonstrate its financial viability.

In July 1998, the DOE issued Charter School Technical Advisory 98-1, which advised charter schools that they were required to follow sound business practices and generally accepted government auditing standards as conditions of their charters. The Technical Advisory outlined three essential elements of sound business practices:

- a documented system of internal controls;
- a documented procurement process that promotes competition, fairness, and best value contracting; and
- written policies and procedures ensuring that the school's procurement process is consistent with and based upon its internal control system and requiring sufficient record-keeping for audit purposes.

The Office's review disclosed weaknesses in the financial management of some charter schools and in the DOE's oversight of charter schools' financial operations. These weaknesses undermine the accountability of the charter school initiative and increase the financial risks to state taxpayers.

Finding 9. **The lack of uniformity of the audited financial statements submitted to the DOE by charter schools reduces their usefulness as a financial monitoring tool.**

Finding 10. **Three charter schools exhibited warning signs of financial problems that, if uncorrected, could jeopardize their future viability.**

Finding 11. **Independent auditors of 17 charter schools reported deficient internal control systems that could adversely affect the efficiency and integrity of the schools' business operations.**

- **Some charter schools have reportedly taken timely actions to strengthen their internal control systems in response to deficiencies cited by their independent auditors.**
- **Some charter schools have reportedly failed to take timely actions to correct previously identified deficiencies in their internal control systems.**

Finding 12. **DOE oversight of charter schools' financial condition and business practices has been inadequate.**

- **Charter schools are not currently required to provide the DOE with management letters issued by their independent auditors reporting on internal control deficiencies.**
- **The annual reports issued by some charter schools have not consistently complied with financial reporting requirements.**

Procurement Procedures

Massachusetts public elementary and secondary schools are required to follow the competitive procedures of M.G.L. c. 30B in procuring supplies, services, and real property. M.G.L. c. 30B, which applies to approximately 1,500 local governmental jurisdictions in Massachusetts, requires the solicitation of informal price quotations for supply and service contracts from $1,000 to $9,999 and formal, advertised competition using sealed bids or proposals for supply and service contracts of $10,000 or more. M.G.L. c. 30B also sets forth competitive procedures for disposing of surplus supplies and acquiring or disposing of real property.

The charter school law contains no competitive requirements for charter school purchases. However, Chapter 46 of the Acts of 1997, which amended the charter school law, contained a provision requiring charter school administrators serving as procurement officers to participate in and obtain certification in the Massachusetts Certified Public Purchasing Official (MCPPO) program conducted by the Office of the Inspector General. In addition, Horace Mann charter schools are subject to the provisions of M.G.L. c. 30B.

In July 1998, the DOE issued Charter School Technical Advisory 98-1 advising charter schools that they were required, as a condition of their charters, to follow sound business practices. The advisory stated that sound business practices would include procurement procedures that maximize competition, give potential offerors sufficient information upon which to base their offers, and specify an evaluation method that defines and produces the best value offer.

Six months after the DOE issued this advisory, the Office reviewed the written procurement procedures developed by the 24 schools in this review. The Office's review of each school's procedures addressed two questions:

- Did the school adopt written procurement procedures, as required by the 1998 DOE advisory?
- If so, did the school's written procurement procedures require formal competition and best value contracting, as required by the DOE advisory?

The Office's review disclosed that many charter schools had not developed written procurement procedures by January 1999. Of those that had developed written procurement procedures, most did not require advertised competition for any purchases, although some schools indicated in letters to the Office that they have attempted to seek informal competition for some purchases.

Finding 13. More than half of the 24 charter schools lacked written procurement procedures.

Finding 14. The written procurement procedures adopted by nine charter schools did not require advertised competition for purchases of supplies, services, and equipment.

Facility Leasing

The task of locating and paying for an adequate school facility poses a daunting challenge to prospective founders of charter schools as well as to newly chartered schools. The charter school law prohibits Commonwealth charter schools from receiving state school building assistance funds for school construction, reconstruction, or improvement work. However, the state's budget for the 1999 fiscal year included funds for grants to support charter school leasing and construction of facilities.

The Office's review of 41 real property agreements provided to the Office by the 24 charter schools in this review showed that all 24 schools occupied leased facilities as of July 1998. In some cases, these agreements had been amended to change the lease payments, add space, or extend the lease term.

The lessees for facilities used by seven of the 24 schools between March 1995 and July 1998 were not the schools themselves; in each case, the private non-profit corporation established to provide support to the school was the lessee, although the school paid the rent or occupancy charges under the lease agreement. Documents provided to the Office by the schools indicated that the schools had not executed written sublease agreements with the private non-profit corporations leasing the facilities.

The lease costs of the 24 charter schools in this review exceeded $3 million in the 1998 fiscal year. The lowest expenditure for the 1998 fiscal year was $40,000; the highest was $583,600. For all schools, lease costs as a percentage of total school expenditures totaled approximately seven percent in the 1998 fiscal year. For individual schools, lease costs as a percentage of total school expenditures ranged from four percent to 14 percent in the 1998 fiscal year.

Finding 15. Charter schools' unadvertised, noncompetitive real property transactions are vulnerable to waste and abuse.

- **Six charter schools leased their facilities from related parties or organizations.**
- **By funding noncompetitive, negotiated facility costs, the Commonwealth's $2.8 million facility grant program for charter schools will not promote best value leases.**

Finding 16. Some facility information provided to the DOE in the charter school applications has proved speculative and unreliable.

Finding 17. Charter schools have not complied with the beneficial interest disclosure requirements contained in M.G.L. c. 7, §40J.

Conclusion and Recommendations

The findings summarized in this report focus exclusively on the business policies and practices of the 24 Massachusetts charter schools in this review. To date, charter school business operations have received little scrutiny. Both nationally and within Massachusetts, the debate over the charter school movement has focused primarily on educational effectiveness. The philosophy of the charter school movement is that charter schools should be free to use whatever means and processes they choose as long as the educational results are satisfactory. In Massachusetts, charter schools are evaluated primarily on the basis of the academic progress of their students.

While charter schools are required to comply with some of the same laws and regulations – such as health, safety, and antidiscrimination laws – that apply to other public schools, charter schools are not subject to the same legal rules governing their business operations. Unlike other public schools in Massachusetts, charter schools are not required to procure supplies, services, and real property using the competitive procedures of M.G.L. c. 30B. In addition, charter schools are permitted to incur short-term debt without being subject to the legal restrictions on borrowing by Massachusetts cities and towns.

This report identifies weaknesses in the contracting practices, internal controls, and procurement procedures of many charter schools in this review. If left uncorrected, these weaknesses are likely to undermine the schools' ability to achieve their educational objectives; they also jeopardize the interests of state taxpayers whose dollars fund those schools. These findings may be attributable in part to inadequate administrative resources. Individuals with the necessary talent, expertise, and dedication to design and implement innovative educational methods do not necessarily possess the necessary expertise, time, and motivation to develop effective internal control systems and procurement procedures. Although the DOE has informed charter schools that they are obligated to follow sound business practices – including the adoption of written procurement procedures that maximize competition – as conditions of their charters, the DOE has not taken steps to monitor compliance with these requirements.

In theory, the DOE's authority to revoke or deny renewal of charters to schools whose operational or financial viability is judged inadequate provides a sufficient incentive for charter schools to institute sound business practices. This theory remains largely untested: as of November 1999, the DOE had neither revoked nor denied renewal of any charters. However, the fact that the DOE's charter renewal criteria do not entail an explicit evaluation of charter schools' business practices may have reduced the likelihood that charter schools would devote scarce resources to this area of operations.

It has also been argued that the strict budgetary limitations imposed on charter schools by the state's tuition formula provide the necessary safeguards against wasteful or inappropriate charter school expenditures. However, the Office's review revealed that some charter schools are not operating within these budgetary restrictions; instead, they have incurred substantial debts in order to supplement their state tuition payments and other sources of income. The Commonwealth could, in some circumstances, be liable for the outstanding financial obligations of these schools if the DOE revoked or failed to renew their charters. Thus, the financial exposure of these charter schools could pose significant risks to state taxpayers. If the current cap of 37 Commonwealth charter schools is increased or removed, and the number of Commonwealth charter schools

increases, the outstanding financial obligations of these schools – and corresponding risks to state taxpayers – will escalate further.

Efficient, cost-effective business practices that reduce the risks of waste and abuse will further a charter school's educational mission. Conversely, inefficient business practices that invite waste and abuse will consume resources that could and should be devoted to improving the educational performance of the charter school's students. Strengthening charter school business operations is therefore in the interests of all charter school stakeholders: the schools themselves, parents, students, and state taxpayers.

Accordingly, the recommendations provided in this report are aimed at accomplishing this objective by implementing two policy initiatives: best value contracting and proactive oversight. These initiatives are discussed in further detail below.

Best Value Contracting

A central premise underlying the charter school initiative, nationally as well as in Massachusetts, is that a market-driven educational system will promote innovation, efficiency, and accountability on the part of charter schools as well as regular school systems. Despite the competitive model on which charter schools were founded, the charter school movement has not taken the lead in applying similar market principles to charter schools' business transactions, nor has this issue been a focus of the charter school literature.

The decision to contract out public functions to the private sector is a policy decision that may entail value judgments and accountability considerations as well as efficiency and cost analyses. However, when a charter school – or any other public entity – does decide to contract with the private sector, it should do so in an accountable manner that obtains the best value for the public dollar by taking into consideration its quality and performance objectives as well as price. The strategy of fostering competition in the private marketplace on the basis of quality, performance, and price is commonly referred to as "best value contracting." Competition is a key element of best value

contracting. Research has consistently demonstrated that without the discipline of the competitive marketplace, contracts for supplies and services with the private sector are neither efficient nor cost-effective.

The DOE has instructed charter schools to develop competitive procurement procedures. However, only two of the 24 schools in this review had developed written procedures requiring advertised competition. This finding suggests that the current approach of encouraging each charter school to invent its own procurement procedures is unlikely to result in accountable procurements that promote best value contracting.

Since the enactment of M.G.L. c. 30B in 1990, more than 1,500 local jurisdictions in Massachusetts – including local and regional school districts – have conducted best value procurements for their supplies, services, and real property acquisitions. Horace Mann charter schools are also subject to the requirements of M.G.L. c. 30B. Thus, most vendors serving Massachusetts public schools are familiar with M.G.L. c. 30B and accustomed to competing for school contracts. Charter school procurement officers are already required to participate in the Massachusetts Certified Public Purchasing Official (MCPPO) program, which offers three seminars on best value contracting. The most efficient means of ensuring best value contracting by charter schools is to require them to use the widely accepted and well-documented competitive procedures of M.G.L. c. 30B.

Some private management contractors providing comprehensive educational and administrative services to Massachusetts charter schools are selected by the charter school founders before the schools are chartered. To address these circumstances, the recommendations in this report would exempt these management contracts from the competitive requirements of M.G.L. c. 30B in cases where the management contractor was selected prior to and included in the original charter application. In these cases, the DOE would be responsible for conducting a full assessment of the management contractor's qualifications and price to provide the services specified in the application.

Otherwise, this report recommends that each charter school electing to contract with a private management contractor for educational and administrative services – or for

administrative services exclusively – be required to develop a detailed scope of work, including performance standards and requirements, for the services to be procured; conduct an advertised competition; evaluate and compare offers from qualified contractors; and select the best offer. This market-driven approach to contracting for management services would increase the likelihood of obtaining high-quality services on favorable terms. While incumbent management contractors may prefer not to be required to compete for charter school contracts, the prospect of initial vendor resistance should not deter charter schools, the DOE, and the Legislature from promoting competition and accountability through best value contracting.

Proactive Charter School Oversight

Charter school proponents on the national level have begun to recognize the need to shore up the business side of charter school operations if the charter school movement is to survive over the long term. For example, the Hudson Institute, whose "Charter Schools in Action" project generated two major reports on its research on charter schools in 14 states, including Massachusetts, has cited the "lack of business acumen and managerial competence" as a start-up problem that charter schools themselves need to address.

To strengthen charter schools' business operations, the second policy initiative recommended in this report is an effective and reliable system within the DOE for conducting proactive oversight. The starting point for this system is the DOE's charter school application process, which should enable the DOE to conduct a meaningful evaluation of the administrative and financial capacity of charter school applicants. The Accountability Plan developed by newly chartered schools should include a business plan for the school's operations and finances. As part of its oversight function, the DOE should provide assistance to new and existing charter schools to facilitate the adoption of sound business systems and practices. To ensure genuine accountability, the DOE must also establish reliable methods of monitoring each school's financial condition, internal control systems, and compliance with its business plan.

Although the Massachusetts charter school law is considered a strong state oversight model on a national level, the oversight requirements of the law have not been fully or effectively implemented. The DOE has recently taken steps to improve its charter school oversight function. However, notwithstanding the evident dedication of the two professional staff members of the DOE's charter school office, the charter school office has lacked sufficient staff resources to provide effective, proactive oversight of the business operations of Massachusetts charter schools.

The recommendations provided below would benefit the charter school community and state taxpayers by improving DOE oversight in at least three areas. First, the DOE would ensure that newly chartered schools possess sufficient resources and information to institute and administer sound business policies and practices. Deficient business operations and noncompetitive procurement methods are unlikely to improve charter schools' educational outcomes, nor is there any evidence that Massachusetts charter schools have developed innovative administrative systems or procedures that are worthy of replication.

Second, the DOE would identify and address operational problems at charter schools before these problems became insurmountable. Charter school advocates within the research community have raised legitimate concerns about the appropriateness of relying on the chartering agency's ability to shut down a school as the primary tool for holding schools accountable.

And third, the DOE would ensure genuine administrative accountability by holding all charter schools to clear standards of financial and operational performance. After five years, when a charter school applied to the DOE to renew its charter, the DOE would have compiled full information on the school's operations and track record.

This policy initiative will require the Commonwealth to increase its investment in charter school oversight. The DOE's charter school office will require additional staff resources in order to fulfill its current oversight responsibilities and to implement the recommendations listed below.

Recommendations

The Inspector General recommends the following measures to strengthen the Massachusetts charter school initiative, increase charter school accountability, and protect the public's investment in charter schools:

1. **The DOE should strengthen and systematize its oversight of charter schools' business operations and financial condition.**

2. **The DOE should require each charter applicant to submit a detailed business plan for administering the school's operations and finances.**

3. **Charter schools should be required to use the competitive procedures of M.G.L. c. 30B to procure supplies and services, and to acquire and dispose of real property.**

4. **The DOE should provide charter schools with comprehensive information on their legal obligations.**

5. **The DOE should ensure that the Board of Education has approved the terms of all educational services contracts requiring Board approval.**

6. **The DOE should develop and disseminate sample management contract provisions that protect the interests of charter school students, other public school students, and state taxpayers.**

7. **The DOE should contract for and disseminate prototype accounting manuals for larger and smaller charter schools.**

8. **The DOE should improve and standardize the annual independent audits conducted at charter schools.**

9. **The DOE should devote the necessary additional resources to ensure effective, proactive charter school oversight.**

I. Introduction

Legislation authorizing the establishment of public charter schools in Massachusetts was enacted in 1993 as Massachusetts General Laws Chapter 71, Section 89 and subsequently amended in 1995, 1996, 1997, and 1998. The charter school law establishes the Board of Education as the charter-granting authority in Massachusetts. The Department of Education (DOE), under the supervision of the Board of Education, administers the charter application process; the DOE also provides assistance to and oversight of Massachusetts charter schools.

Chapter 46 of the Acts of 1997, which amended the charter school law, directed the Office of the Inspector General to conduct a study of operations, practices, and activities at the established charter schools in the Commonwealth, including but not limited to:

> [A]n analysis and evaluation of contracting practices and related matters and whether any procedures, practices, programs or measures may be employed or implemented to ensure that the charter schools are in conformance with state laws governing contracting, related-party transactions, record keeping and the expenditure of public funds.

The Office initiated this charter school study in March 1998. Consistent with Chapter 46, which was enacted on July 11, 1997, the Office identified 25 charter schools that had been established as of July 31, 1997. The operation of one of the 25 schools, YouthBuild Boston Charter School, had been suspended since December 1996 due to concerns about the quality of its educational program and the school's organizational viability. The Board of Education voted to dissolve its charter school contract with the YouthBuild Boston Charter School in February 1998. The Office thus excluded the school from the scope of this review.

In conducting this review, the Office reviewed records obtained from the DOE as well as from the 24 charter schools listed below:

Academy of the Pacific Rim
Atlantis
Benjamin Banneker
Benjamin Franklin Classical
Boston Renaissance
Boston University Residential
Cape Cod Lighthouse
Chelmsford Public
City on a Hill
Community Day
Francis W. Parker
Hilltown Cooperative
Lawrence Family Development
Lowell Middlesex Academy
Lynn Community
Marblehead Community
Martha's Vineyard
Neighborhood House
North Star Academy
Pioneer Valley Performing Arts
SABIS International
Seven Hills
Somerville
South Shore

The Office also conducted interviews with officials of the DOE's charter school office. The Office appreciates the DOE's assistance and cooperation during the course of this review.

This report focuses on the business operations of the 24 charter schools in this review. The report findings highlight weaknesses that could undermine charter schools' ability to achieve their educational objectives and jeopardize the interests of state taxpayers, whose dollars fund charter schools. The report recommendations are aimed at strengthening the Massachusetts charter school initiative, increasing charter school accountability, and protecting the public's investment in charter schools.

In September 1999, the Office provided the DOE with a confidential draft of this report. In his written comments on the draft, the DOE Commissioner stated that the Office's review had provided the DOE with valuable information, expressed agreement with many of the major findings of the report, and provided additional comments and information relating to the report findings and recommendations. The DOE Commissioner's response also identified several recently implemented measures as well as measures currently being implemented by the DOE to strengthen its charter school oversight function. The DOE Commissioner's full response is provided in Appendix A of this report. The DOE Commissioner's comments have also been noted in the relevant sections and findings of this report.

Background on Charter Schools

Charter schools represent one facet of a national reform movement that has promoted and engendered innovative public education approaches and organizational arrangements in many states, including Massachusetts. As independent public schools, charter schools operate under charters, granted by state or local jurisdictions, that outline the schools' educational objectives and their plans for achieving those objectives. Although the rules governing charter school arrangements vary significantly from state to state, charter schools are generally permitted to operate independently, without having to comply with many regulations that apply to other public schools. Like other public schools, however, charter schools may not charge tuition, must be nonsectarian, and must comply with federal and state antidiscrimination, health, and safety laws.[1]

Accordingly, charter schools are generally free to establish their own curricula, hire their own staff, and control their own finances. In return, charter schools are expected and obligated to fulfill the objectives of their charters. Charter school terms vary from state to state. Generally, they range from three to five years. The charter-granting jurisdiction may revoke the charter of a charter school that fails to achieve its objectives. This arrangement is intended to foster innovation while ensuring educational accountability. According to the Institute for Responsive Education at Northeastern University, which has studied the charter school movement since 1992:

> [C]harter schools may be laboratories for innovation, places where educators can explore new teaching methods and better ways to forge school-family partnerships, and places where other educators can learn if these techniques can work.[2]

An underlying premise of the charter school concept is that introducing competition into the public education system will have beneficial effects. In a 1997 handbook for charter

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[1] U.S. Department of Education, National Institute on Educational Governance, Finance, Policymaking and Management, *The Charter School Roadmap* (1998), 1.

[2] Abby R. Weiss, *Going It Alone: A Study of Massachusetts Charter Schools* (Institute for Responsive Education, 1997), 4.

school founders, the Boston-based Pioneer Institute emphasized the value of charter schools as a form of "market-driven education":

> Advocates of a more market-driven education system believe charter schools are a significant step in the right direction. Because charter schools are funded on the basis of their enrollment, they are forced to attract and satisfy the educational consumer and, in so doing, they introduce meaningful competition into the educational system.[3]

Similarly, a 1998 report on the Massachusetts charter school initiative issued by the DOE cited competition as a positive force for improving public education:

> Charter schools were created to provide more choices in public education, encourage competition among public schools, and spur innovation in pursuit of improved educational outcomes. . . . [C]hoice means competition, which is a force that often hastens change and improvement in any organization or system.[4]

As of September 1998, there were approximately 1,050 charter schools operating 1,129 sites (including multiple branches operating under a single school charter) in 27 states and the District of Columbia.[5] The federal government provides grant funds and technical assistance to charter schools as well as to other public schools. The U.S. Department of Education budget for charter schools increased from $51 million in the 1997 fiscal year to $100 million in the 1999 fiscal year; for the 2000 fiscal year, the Department requested $130 million to stimulate the creation of 3,000 charter schools over the next decade.[6]

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[3] Pioneer Institute for Public Policy Research, Charter School Resource Center, *Massachusetts Charter School Handbook* (1997), 2.

[4] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 2-8.

[5] U.S. Department of Education, Office of Educational Research and Improvement, *The State of Charter Schools: Third-Year Report* (1999), Executive Summary.

[6] U.S. Department of Education, *FY 2000 Budget Summary* (Online, accessed January 1999). Available from http://www.ed.gov/offices/OUS/Budget00/BudgetSum/sum-a.html/#charterschools.

Charter Schools in Massachusetts

Massachusetts was one of the first five states in the country to undertake a charter school initiative. The Massachusetts charter school law, M.G.L. c. 71, §89, sets forth seven purposes for establishing charter schools:

1. to stimulate the development of innovative programs within public education;
2. to provide opportunities for innovative learning and assessments;
3. to provide parents and students with greater options in choosing schools within and outside their school districts;
4. to provide teachers with a vehicle for establishing schools with alternative, innovative methods of educational instruction and school structure and management;
5. to encourage performance-based educational programs;
6. to hold teachers and school administrators accountable for students' educational outcomes; and
7. to provide models for replication in other public schools.

The charter school law authorizes the creation of two types of charter schools: Commonwealth charter schools and Horace Mann charter schools. The DOE's charter school application materials provide the following descriptions of these two types of charter schools:

> [A Commonwealth charter school is a] public school that operates independent of any school committee under a five-year charter granted by the Board of Education. It is started by parents, teachers, non-profit organizations, or community leaders. It has the freedom to organize around a core mission, curriculum, theme, or teaching method, and is allowed to control its own budgets, [and] hire (and fire) teachers and staff. In return for this freedom, a charter school must attract students and produce results within five years or have its charter revoked. . . .
>
> [A Horace Mann charter school is a] former district public school or part of a public school that operates under a five-year charter approved by the local school committee, the local teacher's union president and the Board of Education. To the extent provided by the terms of their charters, Horace Mann charter schools may be exempt from local collective

bargaining agreements, provided that employees of the school will remain members of the local collective bargaining unit, continue to accrue seniority, and will receive, at minimum, the salary and benefits established by the local collective bargaining unit.

By early 1997, the Board of Education had awarded 25 charters, the maximum number allowed under the charter school law in effect at that time.[7] Legislation enacted in July 1997 amending the charter school law[8] increased this cap from 25 to 50, and the Board of Education approved 13 additional charters in 1998. According to DOE projections, there would be 32 Commonwealth charter schools and five Horace Mann schools operating within Massachusetts by the end of 1999.[9]

When the Office initiated this review in March 1998, no Horace Mann charter schools had been established; accordingly, no Horace Mann charter schools were included in the scope of this review. Thus, the findings regarding charter schools contained in this report relate exclusively to Commonwealth charter schools.

The Chartering Process[10]

Under the charter school law, charter school applications may be submitted by a non-profit entity, two or more certified teachers, or 10 or more parents. Commonwealth charter schools are supervised and controlled by boards of trustees. For-profit entities, including for-profit firms and private schools, are ineligible to apply for charters. However, charter schools may contract with private non-profit or for-profit entities for educational or other services.

The charter application process includes several stages of review by the DOE. Applicants whose initial application materials are determined to meet the evaluation criteria established by the DOE are invited to submit a final application of no more than

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[7] As noted above, one school's charter was dissolved in early 1998.

[8] Chapter 46 of the Acts of 1997.

[9] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 11.

[10] The information in this section is drawn from the DOE's charter school application.

50 pages, providing a detailed narrative, proposed budget, and action plan as well as attachments containing letters of support, résumés of potential board of trustees members, and other relevant documentation.

Charter School Funding

Commonwealth charter schools receive state funds under M.G.L. c. 70, which establishes standards for state funding of public schools in Massachusetts. State aid to charter schools is calculated according to a tuition formula based on the number of enrolled students and the average cost per student in the school districts in which the charter school students reside. The state then deducts equivalent funds from the state aid accounts of those same school districts. However, local districts have been reimbursed by the state for charter school payments. Reimbursements have varied from 30 percent to 100 percent of charter school payments. Total state reimbursement to school districts exceeded $24 million in the 1999 fiscal year.

The DOE's charter school application provides the following explanation of the per student tuition payment received by charter schools:

> If the district where a student lives (i.e., sending community) spends below its so-called "foundation budget,"[11] the payment to the charter school will equal the sending community's average cost per student. If the sending community spends above its foundation budget, the tuition payment will equal the average cost per student in either the community in which the charter school is located or the community where the student lives, whichever is less.

According to the DOE's published statistics, charter schools in Massachusetts received close to $45 million in M.G.L. c. 70 funds in the 1998 fiscal year.[12] In addition, charter schools, like other public schools, may receive federal and state grant funds. According to the audited financial statements and annual reports of the 24 schools in this review,

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[11] A school district's foundation budget is its minimum education spending level, as defined in M.G.L. c. 70, §2.

[12] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 14.

the schools received grant funds totaling more than $4.7 million in the 1998 fiscal year. Under the charter school law, charter schools may incur temporary debt in anticipation of receiving funds, provided that the terms of repayment may not exceed the duration of the school's charter without the approval of the Board of Education.[13] Charter schools may also receive funds and other donations from private donors.

Charter School Accountability

The charter school initiative, both nationally and in Massachusetts, is designed to require performance-based accountability. In a publication entitled *The Massachusetts Charter School Initiative Evaluation and Accountability Policy*, the DOE has cited charter school accountability as an innovative and unprecedented phenomenon distinguishing charter schools from other public schools in Massachusetts:

> Massachusetts charter schools are becoming the most accountable public schools in the Commonwealth. For the first time in the history of public education, public schools are being allowed to set their own high standards, demonstrate performance against those standards, and – here's the real difference – they will be closed down if they don't produce good results.[14]

According to the *Policy*, charter school accountability is a function of objectives, progress toward objectives, and consequences based on performance:

> Real accountability can be recognized by looking for three necessary elements: worthy objectives, credible measures of progress toward those objectives, and consequences (both rewards and penalties) based on performance. Charter schools in Massachusetts have all three elements of accountability, although it is the possibility of real consequences that make charter schools the exception to the rule in public education, for they must prove themselves worthy of public money after five years or face extinction.[15]

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[13] M.G.L. c. 71, §89(j)(6).

[14] Massachusetts Department of Education, *The Massachusetts Charter School Initiative Evaluation and Accountability Policy* (undated), 1.

[15] Ibid.

To guide the determination of whether a charter school should receive public funds, the *Policy* sets forth three questions:

1. Is the academic program a success?
2. Is the school a viable organization?
3. Is the school faithful to the terms of its charter?[16]

The charter school law requires each charter school to submit an annual report to the Board of Education, the local school committee, each parent or guardian of its enrolled students, and each parent or guardian contemplating enrollment of a student in that charter school. The charter school law also requires each charter school to submit an independent audit of its accounts each year to the DOE and the State Auditor.[17] In addition, the DOE requires each charter school to submit an Accountability Plan at the end of its first year of operation and to report annually on its progress in meeting the performance objectives set forth in the plan. The Accountability Plan is intended to serve as a contract between the state and the charter school that establishes the criteria by which the school will be held accountable over the life of its charter. According to the DOE's 1998 report on the Massachusetts charter school initiative:

> A charter school will be judged primarily on the academic progress of its students, not by how much it pays its teachers or how well it complies with conventional educational practices and assumptions.[18]

State Oversight of Charter Schools

A charter school office within the DOE is responsible for overseeing and providing technical assistance to Massachusetts charter schools. The charter school office was located within the Executive Office of Education (EOE) until 1996, when legislation was enacted to abolish the EOE.[19] Since 1996, the charter school office has been located

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[16] Ibid.

[17] M.G.L. c. 89, §71 (gg), (hh).

[18] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 18.

[19] Chapter 57 of the Acts of 1996.

within the DOE, under the supervision of the Board of Education.[20] Until February 1999, the charter school office included three full-time professional staff: an Associate Commissioner, who reported directly to the Commissioner of Education, and two Assistant Directors for Charter Schools. In February 1999, the Associate Commissioner left state service, and an Assistant Director assumed the position of Acting Associate Commissioner.

The responsibilities of the DOE's charter school office include, but are not limited to, evaluating new charter applicants; assisting newly chartered schools; monitoring the performance of charter schools in improving the academic performance of charter school students; reviewing charter school reports; disbursing state aid to charter schools; and evaluating renewal applications.[21] According to DOE officials interviewed by the Office, the charter school office is assisted by several other offices within the DOE, including the legal, grants management, and finance offices.

Profiles of Charter Schools in This Review

Table 1 contains summary information regarding the 24 schools in this review, all of which were granted charters between 1994 and 1996. Fourteen of the schools opened in 1995, seven opened in 1996, and three opened in 1997. The schools are located across the state in both urban and rural settings, as far west as Williamsburg and as far east as Orleans. They serve some of Massachusetts's biggest cities – Boston, Worcester, and Springfield – as well as smaller towns such as West Tisbury and Hadley. The schools, each chartered under its own unifying theme or mission, embody a variety of educational philosophies and curricula. While some schools have adopted a traditional approach to learning, others have become testing grounds for new educational methods.

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[20] Chapter 151 of the Acts of 1996.

[21] In response to a draft version of this report, the DOE Commissioner stated that both the former EOE and the DOE chose to focus the bulk of their limited charter school oversight resources on charter school accountability for academic performance.

Table 1. Profile of Charter Schools in This Review

School	Location	Year Chartered	Year Opened	Grades FY96	Grades FY97	Grades FY98	Number of Students FY96	Number of Students FY97	Number of Students FY98
Academy of the Pacific Rim	Hyde Park	1995	1997			6-7			99
Atlantis	Fall River	1994	1995	K-5	K-6	K-7	219	337	419
Benjamin Banneker	Cambridge	1995	1996		3-5	K-6		195	252
Benjamin Franklin Classical	Franklin	1994	1995	K-4	K-5	K-6	149	198	255
Boston Renaissance	Boston	1994	1995	K-5	K-8	K-8	617	1,057	1,072
Boston University	Granby	1994	1997			7-12			12
Cape Cod Lighthouse	Orleans	1994	1995	6-8	6-8	6-8	128	162	165
Chelmsford Public	Chelmsford	1995	1996		5-8	5-8		154	174
City on a Hill	Boston	1994	1995	9-10	9-11	9-12	65	99	142
Community Day	Lawrence	1994	1995	K-4	K-5	K-6	110	132	196
Francis W. Parker	Devens	1994	1995	7-8	7-9	7-10	119	185	250
Hilltown Cooperative	Williamsburg	1994	1995	K-4	K-5	K-6	39	55	73
Lawrence Family Development	Lawrence	1995	1995	K-3	K-4	K-5	179	237	296
Lowell Middlesex Academy	Lowell	1994	1995	9-12	9-12	9-12	100	100	104
Lynn Community	Lynn	1996	1997			K-5			144
Marblehead Community	Marblehead	1994	1995	5-7	5-8	5-8	136	171	175
Martha's Vineyard	West Tisbury	1995	1996		3-9	3-10		75	104
Neighborhood House	Dorchester	1994	1995	K-2	K-5	K-6	51	104	125
North Star Academy	Springfield	1995	1996		9-12	9-12		70	109
Pioneer Valley Performing Arts	Hadley	1996	1996		9	9-10		63	133
SABIS International	Springfield	1995	1995	K-7	K-8	K-9	447	599	748
Seven Hills	Worcester	1994	1996		K-7	K-8		512	662
Somerville	Somerville	1996	1996		K-8	K-9		447	544
South Shore	Hull	1994	1995	K-2, 6-12	K-12	K-12	150	324	339
			Median				132	171	175
			Total				2,509	5,276	6,590

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Table 1. Profile of Charter Schools in This Review (continued)

School	Revenues						Expenditures					
	FY96		FY97		FY98		FY96		FY97		FY98	
	c. 70	Total*	c. 70	Total*	c. 70	Total*	Total	Per student	Total	Per student	Total	Per student
Academy of the Pacific Rim					746,908	933,078					805,613	8,164
Atlantis	1,217,304	1,339,725	1,964,446	2,292,900	2,491,111	2,948,741	1,309,353	5,968	1,919,482	5,694	2,517,789	6,015
Benjamin Banneker			1,807,141	2,429,221	2,415,961	2,757,735			2,164,501	11,122	2,551,402	10,142
Benjamin Franklin Classical	630,719	760,336	1,000,037	1,072,987	1,384,048	1,510,082	628,000	4,213	940,533	4,747	1,221,766	4,798
Boston Renaissance	4,231,317	14,374,900	7,752,930	11,285,235	8,220,713	8,933,278	15,631,565	25,339	10,915,012	10,322	8,479,151	7,907
Boston University					65,818	514,768					1,070,901	91,452
Cape Cod Lighthouse	830,159	916,111	1,233,702	1,298,161	1,344,963	1,378,195	720,048	5,632	1,106,933	6,843	1,259,290	7,652
Chelmsford Public			773,519	932,307	983,267	1,220,412			853,050	5,545	1,098,925	6,313
City on a Hill	445,835	768,582	722,495	1,354,101	1,085,812	1,648,259	564,614	8,686	1,037,955	10,533	1,585,888	11,197
Community Day	627,045	835,297	820,658	1,205,500	1,261,070	1,528,681	711,218	6,483	954,189	7,229	1,578,334	8,055
Francis W. Parker	638,928	906,538	1,056,009	1,353,621	1,477,012	1,981,442	786,380	6,592	1,281,125	6,919	1,864,804	7,446
Hilltown Cooperative	200,727	304,974	282,183	328,262	368,620	599,020	206,566	5,297	265,735	4,766	562,232	7,737
Lawrence Family Development	1,018,367	1,396,967	1,465,775	1,705,355	1,893,478	2,224,974	1,329,165	7,425	1,677,783	7,094	2,167,187	7,323
Lowell Middlesex Academy	533,783	614,597	584,251	675,241	653,023	875,327	542,901	5,429	646,487	6,466	762,692	7,356
Lynn Community					894,704	1,357,857					1,209,485	8,374
Marblehead Community	769,482	1,002,779	1,050,960	1,240,872	1,151,918	1,421,957	950,437	6,989	1,227,866	7,171	1,303,607	7,442
Martha's Vineyard			602,121	704,307	1,019,203	1,197,064			659,103	8,795	1,023,382	9,850
Neighborhood House	349,123	449,336	761,502	917,179	959,936	1,293,129	402,769	7,913	883,517	8,507	1,331,851	10,636
North Star Academy			403,881	476,918	653,388	869,277			476,304	6,785	842,067	7,723
Pioneer Valley Performing Arts			348,505	496,568	795,596	1,069,527			462,271	7,314	997,317	7,485
SABIS International	2,568,443	2,725,857	3,431,308	3,661,758	4,484,715	4,781,278	2,320,640	5,188	3,343,900	5,580	5,142,714	6,871
Seven Hills			3,007,322	3,447,611	4,266,289	4,766,357			3,348,939	6,537	4,584,905	6,927
Somerville			2,950,422	3,331,527	3,766,277	4,052,742			3,195,445	7,148	3,688,846	6,786
South Shore	787,964	911,510	1,798,527	2,090,668	1,918,892	2,421,799	859,895	5,735	1,879,916	5,811	2,251,276	6,640
Median	**703,446**	**909,024**	**1,050,960**	**1,298,161**	**1,206,494**	**1,466,020**	**753,214**	**6,226**	**1,106,933**	**6,919**	**1,317,729**	**7,568**
Total	**14,829,196**	**27,307,509**	**33,817,694**	**42,300,299**	**44,302,722**	**52,284,979**	**26,963,551**	–	**39,240,046**	–	**49,902,034**	–

* Total revenues and other financing sources

Sources: School audited financial statements (revenues and other financing sources, expenditures), DOE reports (year chartered, year opened, grades, number of students, M.G.L. c. 70 aid)

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In 1998, the 24 charter schools consisted of seven elementary schools, five combined elementary-middle schools, five middle schools, six high schools, and one school serving students in kindergarten through twelfth grade.[22] A total of 6,590 students were enrolled in the 24 charter schools: 1998 enrollments ranged from 12 students to 1,072 students, with a median[23] school enrollment of 175 students.

Revenues

In the 1998 fiscal year, the 24 charter schools in this review received state aid under M.G.L. c. 70 totaling $44,302,722 for 6,590 students. The largest charter school received $8,220,713 in M.G.L. c. 70 funds, while the smallest received $65,818; the median payment of M.G.L. c. 70 funds was $1,206,494 in the 1998 fiscal year. State aid for the 1998 fiscal year ranged from 13 percent to 99 percent of the total revenues received by the 24 schools.

Expenditures

The expenditures[24] reported by the 24 schools totaled $49,902,034 in the 1998 fiscal year; individual school expenditures ranged from $562,232 to $8,479,151. The median school spending was $7,568 per student in the 1998 fiscal year; school expenditures ranged from $4,798 to $11,197 per student.

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[22] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 11.

[23] The median is the middle value in a group of numbers ordered by size. Medians are often used to represent the average when data are heavily skewed, or affected by extreme values. For the statistics provided in this section, a few large schools skew the data and inflate the mean, or arithmetic average; the median is thus more representative of a typical charter school than the mean.

[24] Some audited financial statements reported "expenses" rather than "expenditures," depending upon the financial accounting standard applied by the school. In the interest of simplicity, both categories are generally referred to in this report as expenditures.

Overview of This Report

This report is divided into eight sections, beginning with this report introduction and concluding with the report conclusion and recommendations. Sections II through VII summarize the Office's findings concerning charter schools' contracts with private management contractors; conflict of interest issues affecting charter schools; charter school loans; financial management of charter schools; charter school procurement procedures; and facility leasing by charter schools. Within each section, the charter schools discussed in the findings are listed in alphabetical order. Section VIII of this report presents the report conclusions and the Inspector General's recommendations for strengthening charter schools' business operations.

II. Contracts with Private Management Contractors

Background

Under the charter school law, charter schools are authorized to procure services, equipment, and supplies under contracts and leases with private vendors. The Board of Education is required to approve the terms of any contract with a private entity that will provide "substantially all educational services" to the school.[25]

In June 1998, the Office requested that the 24 charter schools in this review provide the Office with all current contracts and agreements with providers of educational and/or management services. The contracts provided to the Office showed that as of July 1998, five of the 24 charter schools in the Office's review were contracting with private non-profit or for-profit entities to provide substantially all educational services. In each case, the contractor also provided comprehensive administrative services, such as budget, accounting, and payroll functions. Another six of the 24 schools were contracting with private non-profit or for-profit entities to provide comprehensive administrative services.[26] This report refers to the private entities providing these educational and administrative services to charter schools as "management contractors."

Table 2 lists the 11 schools, their management contractors, and the types of services provided under the contracts. As Table 2 shows, five of the 11 schools contracted with non-profit entities (including a community college).[27] Six of the 11 schools contracted with for-profit companies. Three companies – SABIS Educational Systems, Inc.; The

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[25] M.G.L. c. 71 §89(j)(5).

[26] Several of the remaining 13 charter schools had executed specialized educational or administrative services contracts with private contractors. These contracts were more limited in scope than the 11 management contracts discussed in this section.

[27] In one of the five cases, the school contracted with a non-profit management firm, but the contracted services were performed by a for-profit subsidiary of that firm.

Edison Project, L.P.; and Beacon Education Management, LLC – each provided services to two charter schools.

Table 2. Charter School Management Contracts

School	Management Contractor	Type of Organization	Services	Fee Structure	Execution Date
Boston Renaissance	The Edison Project, L.P.	for-profit	educational and administrative	percentage of revenues	April 1995
Chelmsford Public	Beacon Education Management, LLC	for-profit	Educational and administrative	percentage of revenues	July 1998*
City on a Hill	Beacon Education Management, LLC	for-profit	Administrative	flat fee	April 1998
Community Day	Community Day Care Center of Lawrence, Inc.	non-profit	Administrative	percentage of revenues	September 1995
Lawrence Family Development	Lawrence Family Development and Education Fund, Inc.	non-profit	Administrative	percentage of revenues	September 1996
Lowell Middlesex Academy	Middlesex Community College	non-profit	Administrative	flat fee	July 1995
Lynn Community	Massachusetts Health Research Institute, Inc. (Solutions for the Third Sector)	non-profit**	Administrative	percentage of expenses	July 1997
Neighborhood House	Federated Dorchester Neighborhood Houses, Inc.	non-profit	Administrative	percentage of expenses	November 1995
SABIS International	SABIS Educational Systems, Inc.	for-profit	Educational and administrative	unspecified	July 1995
Seven Hills	The Edison Project, L.P.	for-profit	Educational and administrative	surplus revenues	July 1996
Somerville	SABIS Educational Systems, Inc.	for-profit	Educational and administrative	surplus revenues, other charges	July 1996

* The school originally contracted with this contractor, which operated under the name of The Alternative Public Schools, Inc., in June 1996.

** MHRI's subsidiary, Solutions for the Third Sector, is a for-profit firm.

DOE records showed that in eight of the 11 cases, the management contractor was selected by the charter school founders before the founders were granted charters by

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the Board of Education. The DOE's charter school application did not require applicants to submit detailed information regarding the management contractors' qualifications to administer the schools' educational programs and/or administrative operations. In the other three cases, the school apparently selected the management contractor after being granted the charter. Unlike state agencies and local governmental jurisdictions, Massachusetts charter schools are not subject to any law requiring advertised competition for procurements of supplies and services. (Section VI of this report discusses charter school procurements of supplies and services.) Thus, the schools in this review were essentially free to devise their own procedures for selecting management contractors.[28]

The Office's review disclosed that some contracts between charter schools and their management contractors contained provisions that could undermine the schools' ability to achieve their educational objectives. These provisions also jeopardized the interests of state taxpayers whose dollars fund those schools. In cases where the management contractor provided educational as well as administrative services to the school, the Board of Education was required to approve the contracts discussed in this section. In cases where the management contractor did not provide substantially all educational services, the Board of Education was not required to approve, and did not approve, the contracts discussed in this section.[29]

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[28] In 1998, the DOE revised its charter school application to include the following instructions to applicants: "[A]ny application for a charter that proposes a school that would be managed by a non-profit or for-profit contractor should describe why the particular entity was selected and what due diligence the applicant group has performed on said entity." The application material did not specify the method by which the applicant group was expected to perform due diligence on its selected management contractor.

[29] In response to a draft version of this report, the DOE Commissioner noted that the management contracts reviewed by the Office were some of the first in the country and, thus, were designed without the benefit of models specific to this type of contract. He also stated that, like all charter schools, a charter school contracting for educational services is held accountable by the DOE and the Board of Education for its academic and organizational performance, regardless of the terms of its management contract.

Finding 1. Four management contracts for educational services contained no contractor performance requirements measuring students' academic achievement.

Educational accountability is a fundamental objective of the charter school initiative in Massachusetts and elsewhere. Under this results-based model, charter school boards of trustees hold principals and teachers accountable for specific performance outcomes; employees who do not perform risk losing their jobs. Similarly, the DOE holds charter schools accountable for meeting specific performance outcomes. Charter schools that fail to perform risk losing their charters.

However, four of the five contracts executed by charter schools in this review for substantially all educational services did not hold the private management contractors accountable for achieving specific results reflecting students' academic performance.[30] Three contracts specified no performance outcomes at all; the fourth provided that the management contractor's performance would be evaluated on the basis of parent and student satisfaction. The four contracts are discussed in more detail below.

Chelmsford Public Charter School

In March 1996, the Chelmsford Public Charter School contracted with The Alternative Public Schools, Inc. for comprehensive educational and administrative services. The contract was amended in June 1998 to add new provisions and to change the contractor's name to "Beacon Education Management LLC." Under the new contract, Beacon Education Management was responsible for implementing a specific curriculum

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[30] In 1998, several years after the contracts discussed in this section were approved by the DOE and executed by the charter schools, the DOE adopted an explicit policy requiring educational services contracts to contain clear contractor evaluation criteria. Of four educational services contracts executed in 1998 and 1999 by charter schools that were not in the scope of this review, three contracts specified performance requirements reflecting students' academic achievement. The fourth required the school and the contractor to develop an assessment mechanism for evaluating student educational outcomes. In response to a draft version of this report, the DOE Commissioner stated that these more recent contracts represent a positive step forward in the evolution of relationships between charter schools and educational management companies and attest to the DOE's improved oversight of these contracts.

encompassing the vision of the school's charter, hiring all school staff and faculty, and otherwise managing and operating the school. The contract provided that the school would evaluate the Beacon Education Management's performance based on the evaluation criteria contained in an Accountability Plan attached to the contract. The contract provided that high ratings based on the evaluation criteria in the Plan would enable Beacon Education Management to earn a performance bonus and low ratings would enable the school to terminate the contract.

The Accountability Plan attached to the contract specified two evaluation criteria: parent satisfaction and student satisfaction. According to the Accountability Plan, the school and the management contractor would select an evaluation mechanism that included a parent survey and a student survey; both would be designed to evaluate satisfaction with the school's program. The Accountability Plan stated:

> The evaluation shall grade the School's overall program as excellent, good, fair or poor.
>
> The following example of a parent survey question shall serve as a guide for interpretation of the survey results: "Overall, what kind of education do you think the CPCS [Chelmsford Public Charter School] has given your child this year?" "Excellent," "Good," "Fair," "Poor." Where the evaluation gives four (4) points for each "Excellent" response, three for "Good," two for "Fair," and one for "Poor," and assuming parent responses are received for at least 75% of students, then if the composite response of the parents in any year is greater than or equal to 3.25, BEACON's operation of the School would be considered "Excellent"; if less than 3.25 but greater than 2.25 BEACON's operation of the School would be considered "Good"; if less than 2.25 but at least 1.25, BEACON's operation of the School would be considered "Fair"; and if less than 1.25 BEACON's operation of the School would be considered "Poor."
>
> Two consecutive "Fair" or "Poor" ratings, shall be grounds for termination of this Agreement in accordance with Section 6(a)(I).

However, the Accountability Plan contained no contractor performance requirements measuring students' academic achievement.

DOE records show that the DOE's Associate Commissioner wrote to the Chairman of the school's Board of Trustees in May 1998 regarding the school's proposed contract

with Beacon Education Management. The Associate Commissioner's letter requested that the school consider including a provision similar to a provision contained in a proposed contract between Beacon Education Management and the Rising Tide Charter School (which was not among the 24 schools in this review). The provision would have required Beacon Education Management to propose to the school, by a specific date, an assessment mechanism for effective evaluation of student education outcomes; Beacon Education Management and the school would then implement an annual assessment of student outcomes in subsequent contract years. The provision would also have required student achievement results to be reviewed by an independent evaluator. However, the final contract executed by the school did not include the provision suggested by the Associate Commissioner.

SABIS International Charter School

The SABIS International Charter School contracted in August 1995 with the International School of Minnesota, Inc. (referred to in the remainder of this report as "SABIS Educational Systems")[31] to administer the school's educational programs, school's personnel and payroll functions, facilities, food and transportation services, and other business activities. The educational functions for which SABIS Educational Systems was responsible under the contract included student admissions; instruction; bilingual education; student records; special education; student testing; professional development for principals and instructional personnel; and selection and acquisition of instructional materials, equipment, and supplies. The contract stated that the contract had been specifically designed to fulfill six objectives, two of which were to encourage performance-based educational programs and to hold teachers and school administrators accountable for students' educational outcomes. The contract also provided that the school would be authorized to determine the method by which SABIS Educational Systems' progress in educating the school's children would be evaluated.

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[31] According to a Foreign Corporation Certificate filed by the International School of Minnesota, Inc. (ISM) with the Secretary of the Commonwealth in February 1998, ISM conducted business in Massachusetts under the name of SABIS Educational Systems, Inc.

However, the contract contained no specific performance requirements to be met by SABIS Educational Systems. Rather, the contract provided that SABIS Educational Systems would establish minimum student performance outcomes that SABIS Educational Systems itself would be responsible for meeting or exceeding:

> STUDENT OUTCOMES. [SABIS Educational Systems] shall establish minimum outcomes for performance of students enrolled at the Charter School. Such standards of performance shall meet or exceed the minimum standards established by the Commonwealth. It shall be the responsibility of [SABIS Educational Systems] that the students shall meet or exceed the established minimum outcomes.[32]

Seven Hills Charter School

In September 1996, the school contracted with The Edison Project for comprehensive educational and administrative services, including educational programs; all personnel functions; extra and co-curricular activities and programs; professional development for administrators and instructional personnel; and procurement of all instructional materials, equipment, and supplies. The contract required The Edison Project to implement public performance evaluation systems to permit evaluation of the educational progress of each charter school student. The contract also stated:

> Edison shall be responsible and accountable to the Board for the performance of the students who attend the Charter School according to the Massachusetts Education Assessment Program, the performance criteria set out in Appendix D, "Assessment and Accountability Plan," and such other assessment strategies as may hereafter be agreed to in writing by Edison and the Board.

Neither the contract provided by the school to the Office nor the contract on file with the DOE included the appendix containing the Assessment and Accountability Plan referenced in the contract.

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[32] DOE records show that this sentence was added to a draft version of the contract in response to a July 1995 letter from the EOE's General Counsel to the school's attorney. The letter stated that the contract "should provide for accountability by [SABIS Educational Systems] to the extent that the performance of students enrolled does not meet the minimum standards established by the Commonwealth."

The contract also required The Edison Project to design and administer a survey of charter school parents and students to determine their level of satisfaction with the school and to provide the Board with student progress reports that would enable the Board to monitor The Edison Project's educational performance. However, the contract did not specify educational outcomes required under the contract.

Somerville Charter School

In October 1996, the school contracted with SABIS Educational Systems, Inc., to provide comprehensive educational and administrative services to the school, including development and administration of the school's curriculum; student testing; professional development for principals and instructional personnel; and selection and acquisition of instructional materials, equipment, and supplies. The contract stated that one goal of the school's Board of Trustees was "to provide a performance-based educational program emphasizing academic preparedness." The contract also provided that the school would have the right and authority to review the progress of SABIS Educational Systems in educating the school's children.

However, like the contract between SABIS Educational Systems and the SABIS International School, this contract contained no specific performance requirements to be met by SABIS Educational Systems. Rather, the contract provided that SABIS Educational Systems would establish minimum student performance outcomes that SABIS Educational Systems itself would be responsible for meeting or exceeding:

> STUDENT OUTCOMES. SABIS shall establish minimum outcome standards for performance of students enrolled at the School. Such standards of performance shall meet or exceed the minimum standards established by the laws of Massachusetts. It shall be the responsibility of SABIS that the students shall meet or exceed the established minimum outcomes.

In a September 1996 letter to the Co-Chair of the school's Board of Trustees, specifying the changes to the draft contract required as a condition of DOE approval, the DOE Associate Commissioner instructed the school to add "failure to produce satisfactory outcomes" to the list of conditions under which the school could terminate the contract. However, this language was not incorporated into the final contract.

Finding 2. Management contracts executed by some charter schools contained compensation provisions that posed unwarranted risks to the charter schools and taxpayers.

Clear, unambiguous contract provisions stating the basis on which the contractor will be paid are essential to effective contract administration and public accountability. The compensation provisions should provide the contractor with incentives that reflect the public entity's objectives, while protecting the public entity from overcharges and other abuses.

The 11 management contracts reviewed by the Office contained widely varying compensation provisions. The Office did not evaluate the reasonableness of the dollar amounts paid by the schools to their management contractors. However, five of the 11 contracts reflected compensation arrangements that could be detrimental to the interests of the schools or contained compensation provisions that did not correspond to the actual compensation arrangements between the schools and the management contractors. These contracts are discussed below.[33]

Of the six management contracts not addressed in this finding, four contracts contained compensation provisions that based contract fees on varying percentages of the amount of revenues received by the schools. The other two contracts provided for payment of flat compensation fees to the contractors. In general, these types of fee arrangements create more appropriate incentives to contractors than do the provisions discussed below.[34]

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[33] In response to a draft version of this report, the DOE Commissioner stated that the DOE is currently developing a uniform protocol for review and approval of management contracts and that the compensation structure will be a primary focus of the protocol.

[34] However, a June 1999 study of charter school contracting noted that paying a percentage of revenues creates an incentive for the management contractor to increase school enrollments in order to generate more revenue; if increasing enrollments is not a goal of the board of trustees, this compensation arrangement is not recommended. See *Charting a Clear Course* by Margaret Lin and Bryan Hassel (Charter Friends National Network, 1999), 43.

Two contracts based the management contractor's compensation on the school's surplus revenues.

A compensation provision that bases a management contractor's payment on the school's surplus revenues at the end of the fiscal year creates a disincentive for the management contractor to make or recommend certain expenditures that may be warranted, since any expenditure would reduce the school's potential surplus and, thus, the contractor's compensation. This type of compensation provision also eliminates the opportunity for a school to reinvest surplus funds in school operations and to share in the financial benefits of any efficiency measures or cost-saving strategies implemented by either the Board of Trustees or the management contractor during the fiscal year.

In each case cited below, the school's contract indicated that the management contractor was authorized to make expenditures on behalf of the school.

Seven Hills Charter School

Under the school's September 1996 contract with The Edison Project, the contractor was responsible for providing educational and administrative services, including preparation of the school's annual budget for approval by the Board of Trustees. The contract required the school to pay an amount equal to the school's operating budget to The Edison Project, which would pay all school costs and retain any surplus revenues as compensation:

> From the sums received, Edison shall pay all costs for those aspects of the school program for which it is responsible. This shall include, but is not limited to, salaries, health insurance and other benefits, curriculum materials, textbooks, computer and other equipment, software, supplies, etc. and those other costs required to be paid by law as part of the operation of the Charter School. **Any excess of revenue over expenditures shall be deemed compensation to Edison as reimbursement for its technology and other start up costs and for services rendered.** [Emphasis added.]

The school's 1997 and 1998 audited financial statements did not specify the compensation to The Edison Project required or paid under the contract each year.[35]

Somerville Charter School

Under the school's October 1996 contract with SABIS Educational Systems for educational and administrative services, the school was required to pay SABIS Educational Systems all surplus funds from tuition payments:

> The School shall forward all funds received by it for tuition payments from any source to SABIS and SABIS agrees to use such tuition payments (to pay school expenses). . . . **Any surplus remaining from tuition payments after all expenses of the School and the Trustees have been paid shall be retained by SABIS as profit.** In the event that no surplus of funds remains from the tuition payments after expenses of the School and the Trustees have been paid, SABIS shall bear sole financial responsibility for all remaining expenses and neither the School nor the Trustees shall have any obligation to contribute additional funds. [Emphasis added.]

According to the school's audited financial statements, the school owed SABIS Educational Systems a surplus payment of $136,082 in the 1997 fiscal year, in addition to management and other fees (discussed later in this section). The school owed

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[35] According to the school's audited financial statements, the school incurred an "excess of revenues over expenditures and other financing sources" totaling $98,672 in the 1997 fiscal year and $181,452 in the 1998 fiscal year.

SABIS Educational Systems a surplus payment of $343,896 in the 1998 fiscal year, in addition to management and other fees.[36]

Two contracts based the management contractor's compensation on a percentage of school expenses.

A compensation provision that links a management contractor's fee to a school's expenses provides the management contractor with an incentive to increase or recommend increases in school expenses, thereby increasing the contractor's compensation. Rewarding a management contractor for increased expenses may thus encourage spending decisions that do not serve the school's interests, especially when the management contractor is responsible for preparing and administering the school budget. Two charter school management contracts based on this compensation arrangement are discussed below.[37]

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[36] Internal DOE documents show that a similar compensation provision in the draft contract between SABIS Educational Systems and another charter school not included in this review, SABIS Foxborough Regional Charter School, raised concerns within the DOE in late 1998. In an internal memorandum to a DOE attorney dated November 1998, a DOE official questioned the surplus provision in the draft contract: "Why would a surplus go to Sabis if Sabis is already taking a 6% management fee? . . . [(]We have also found that this term is also part of the management contract between Sabis and Somerville Charter School. Should we address this term in the Somerville contract as well?)" In response, the DOE attorney wrote: "The issue of surplus is a policy decision. I certainly agree with you that this provision as worded undermines the spirit if not the letter of the charter school law, particularly because SABIS is already taking 12 percent. With respect to other contracts containing this provision, we must be consistent." A February 1999 letter from the DOE to the Chairman of the school's Board of Trustees letter cited revisions to the draft contract that would be required as a condition of the DOE Commissioner's approval; however, the compensation provision was not one of the provisions identified by the DOE as requiring revision.

[37] Until May 1997, the September 1995 contract between a third school, the Community Day Charter School and the Community Day Care Center of Lawrence, Inc., stated that the management contractor's rate of reimbursement would vary from year to year and would equal approximately eight to 12 percent of the school's operating expenses. In May 1997, this provision was amended to state that the management contractor's rate of reimbursement would equal five percent of "tuitions" – a term that was undefined in the contract.

Lynn Community Charter School

In August 1997, the Lynn Community Charter School contracted with the non-profit Massachusetts Health Research Institute (MHRI)[38] to provide comprehensive administrative services, including bookkeeping, record-keeping, payroll administration, billing to state and federal funding sources, preparation of corporate financial reports required by federal and state laws and regulations, general financial consulting to the school, assistance in selecting an audit firm for required annual audits and hiring of school staff, installation of proprietary accounting software, development of accounting and human resources procedures manuals, and establishment of bank accounts. Under the contract, MHRI's fee was calculated as a percentage of the school's expenses. The contract stated:

> The billing rate for ongoing services will be 3.5% of direct expenses for the period ending June 30, 1998. On or before April 1, 1998, the parties will determine the billing rate for ongoing services for the second 12 months of this Agreement. Such rate shall not be less than 3.5% nor more than 5% of direct expenses.

This contract did not define "direct expenses," nor did it specify whether the management contractor's fee would be based on budgeted or actual direct expenses. The school's audited financial statements provided no information on the management fees paid to the contractor in fiscal 1998, the first year of the school's operation.

Neighborhood House Charter School

Under the November 1995 contract between Neighborhood House Charter School and its management contractor, Federated Dorchester Neighborhood Houses, Inc. (FDNH), FDNH was required to perform all administrative functions of the school, including all personnel, payroll, bookkeeping, and budget preparation functions; all maintenance and operation of the school's facilities; food service; all transportation not provided by the Boston Public Schools; fundraising; and public relations. The contract provided that the

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[38] In a July 1998 letter, MHRI advised the Office that a for-profit subsidiary of MHRI, Solutions for the Third Sector, provided fiscal management services to the school under the August 1997 contract between the school and MHRI.

school would pay FDNH a percentage of the school's direct program expenses, defined as any school costs paid by FDNH in good faith and billed to the school – even unbudgeted or unapproved costs. The contract stated:

> In payment for the services to be performed by [FDNH] hereunder, the School shall pay to [FDNH] an annual fee equal to 5% of the direct program expenses of the School. Such direct program expenses shall equal those amounts billed to the School by Federated for School costs paid in good faith by [FDNH] on behalf of the School.

According to the school's audited financial statements, the school owed FDNH management fees totaling $42,380 in the 1997 fiscal year and $62,127 in the 1998 fiscal year. The audited financial statements reported that these fees were computed at six percent of budgeted direct program expenses. (The discrepancy between the terms of the contract and the fee computation method reported in the audited financial statements is discussed in the following subfinding.) The audited financial statements reported that an unspecified portion of the fees owed by the school to FDNH remained unpaid at the end of both fiscal years.

Three contracts did not accurately reflect the actual compensation arrangements between the schools and their management contractors.

Paying a management contractor without a clear written agreement accurately specifying the basis for payment is not a sound business practice. This approach to contracting diminishes a school's capacity to plan, budget for, and monitor the contract. Public accountability is also compromised when citizens and taxpayers seeking information on the cost of a school's management contract are unable to find this information in the contract itself.

In the first case cited below, the actual payment terms did not correspond to the payment terms contained in the management contract. In the second case, the management contract itself contained no provisions concerning the contractor's management fee, but instead referred to an outdated attachment that projected school revenues and expenses, including management fees. In the third case, the

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management contract contained no provisions regarding the management contractor's compensation.

Neighborhood House Charter School

As discussed in the previous subfinding, the school contracted with FDNH to provide all administrative functions of the school. Although the contract stated that the fee paid to FDNH would equal five percent of direct program expenses billed to the school by the management contractor, the school's audited financial statements stated that the fees owed to FDNH were calculated at six percent of budgeted direct program expenses for the 1997 and 1998 fiscal years. The audited financial statements did not indicate why FDNH's compensation was calculated at six percent rather than five percent of expenses, nor why this calculation was based on budgeted rather than actual expenses billed to the school by FDNH.

SABIS International Charter School

The August 1995 contract between the SABIS International Charter School and SABIS Educational Systems for educational and administrative services did not specify the management fee or basis of compensation. Rather, the contract referred to the contractor's compensation in the following provision:

> [SABIS Educational Systems] shall use the funds provided in accord with the Budget prepared substantially in the form of Attachment 5. In consultation with the teachers, the parties shall agree upon the annual and projected Budgets prior to the commencement of each school year. Attachment 5.1 is the approved Budget for the period July 1, 1995 through June 30, 1996.

Attachment 5.1, appended to the contract, was dated August 8, 1995 and labeled "95/96 Operating Budget." Attachment 5.1 listed budget projections for the 1996 fiscal year that included three separate fees totaling $255,000 to be paid to SABIS Educational Systems: a $160,000 "SABIS Education/Management Fee," a $50,000 fee for "Academic Monitoring System Rental/Main.," and a $45,000 fee for "marketing, community and [SABIS Educational Systems] corp. support." A footnote to Attachment

5.1 stated that the education/management fee and academic monitoring system rental/maintenance fee included a license fee for SABIS Educational Systems proprietary information.

A cover letter to Attachment 5.1 was also attached to the contract. The letter, dated August 10, 1995, and addressed to the school's attorney from the SABIS Educational Systems Vice President of Business Development, stated:

> Attached is the revised 1995/96 operating budget for The Sabis™ International Charter School that should be attached to the most recently changed and revised service contract between The Sabis™ International Charter School and [SABIS Educational Systems].
>
> The main change results from the newly inserted line for license fees for the use of Sabis™ proprietary systems, methods, materials and software in this public school. The fee is computed at 6% of "Total per Pupil Revenue."

This letter appears to have been written in response to requests by the EOE in 1995 for clarification of the license and management fees to be paid to SABIS Educational Systems. In July 1995, the EOE's General Counsel had sent a letter to the school's attorney with comments and requests for additional information concerning the proposed contract between the SABIS International Charter School and SABIS Educational Systems. Under the heading "School Budget and Payment Obligations," the General Counsel's letter stated:

> Payment obligations should be clearly delineated in the Agreement. Financial arrangements between Sabis and [SABIS Educational Systems] should be explained, and a completed budget should be attached indicating categories of revenues and expenses and actual estimates of fixed costs including any fees to [SABIS Educational Systems].

The August 10 letter from the school's attorney was attached to the final version of the contract sent to the EOE on August 22, 1995. On August 30, 1995, the Secretary of Education sent the school's attorney a letter approving the terms of the contract between the school and SABIS Educational Systems as an amendment to the school's charter. The letter stated, in part:

> [T]his approval is conditioned on the filing of an amended 95/96 operating budget for the charter school, clarifying the fee for services and the license fee for [SABIS Educational Systems].

According to the school's audited financial statements, the actual fees charged the school by SABIS Educational Systems for the 1996 fiscal year totaled $448,704 – roughly double the figure of $225,000 projected in Attachment 5.1.[39] Thus, the school's 1995 contract did not accurately reflect its actual compensation arrangements with SABIS Educational Systems during the 1996 fiscal year.

The following table lists the fees charged to the school by SABIS Educational Systems, as reported in the school's audited financial statements. As the table shows, these fees increased by almost $100,000 between the 1996 and 1998 fiscal years. However, the school's contract with SABIS Educational Systems was apparently never amended to reflect the increased fees charged to the school.[40] It should also be noted that the labels of some fees listed in the school's audited financial statements did not correspond exactly to the labels of the fees listed in Attachment 5.1 of the contract between the school and SABIS Educational Systems.

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[39] This increase does not appear to track increases in the school's enrollment: the school's actual per-pupil revenues for the 1996 fiscal year were only 4.7 percent higher than those projected in the operating budget contained in Attachment 5.1 to the contract between the school and SABIS Educational Systems.

[40] Although the school provided the contract to the Office of the Inspector General in July 1998, the budget projections contained in Attachment 5.1 to the contract did not extend beyond June 1996.

SABIS International Charter School Management Contract Fees

	FY 1996	FY 1997	FY 1998
License fee*	$148,958	$217,000	$269,083
Management fee	144,000	217,000	269,083
Corporate support fee	155,746	89,986	5,877
Total	$448,704	$523,986	$544,043

* Labeled "License and Rental Fee" in 1996 audited financial statements.

In December 1998 – more than three years after the EOE's conditional approval – the school's independent auditor raised concerns about the lack of management contract provisions specifying the management and license fees paid to SABIS Educational Systems:

> The management agreement between SABIS Educational Systems and the School does not define the management and license fees to be paid SABIS Educational Systems, Inc. An amendment specifying these fees should be added to prevent future misunderstandings.

The school's audited financial statements reported that the school did not pay SABIS Educational Systems either the license or management fees owed in the 1998 fiscal year; rather, the school deferred payment of this $538,166 obligation, thereby incurring interest charges computed at eight percent of the unpaid fees. However, the school's contract with SABIS Educational Systems did not specify the interest rate to be charged by SABIS Educational Systems on unpaid fees owed by the school.

Somerville Charter School

As previously discussed, the October 1996 contract between the Somerville Charter School and SABIS Educational Systems provided that the school would pay SABIS Educational Systems all surplus funds remaining after all expenses of the school and of

the Trustees have been paid at the end of each year. In addition, the contract referred to a license fee to be paid to SABIS Educational Systems:

> Execution of this Agreement shall give rise to a license for the use of SABIS Proprietary Information to the School (the license fee for which is included in the Budget[)].

The contract did not specify the amount of or basis for calculating the license fee.

According to the school's audited financial statements, SABIS Educational Systems charged the school a total of $683,102 in surplus and fee payments in the 1997 fiscal year and $843,273 in the 1998 fiscal year. The audited financial statements reported that SABIS Educational Systems charged the school a management fee and a corporate support fee in addition to the surplus payment and the license fee referred to in the contract. Both the license fee and the management fee were calculated at six percent of the school's state funding and grant receipts, according to the audited financial statements. The latter did not explain the basis for calculating the corporate support fee. The following table shows the surplus payment and fee charges reported in the 1997 and 1998 audited financial statements.

Somerville Charter School Management Contract Fees

	FY 1997	FY 1998
Surplus payment	$136,082	$343,896
License fee	189,191	228,781
Management fee	189,191	228,781
Corporate support fee	168,638	41,815
Total	$683,102	$843,273

Thus, the school's contract with SABIS Educational Systems did not accurately reflect the school's compensation arrangements with SABIS Educational Systems: it did not

identify or refer to the management and corporate support fees charged by SABIS Educational Systems in the 1997 and 1998 fiscal years.

According to the school's audited financial statements, the school deferred payment of $670,115 of the $683,102 owed to SABIS Educational Systems for the 1997 fiscal year; the following year, the school deferred payment of $697,933 of the $843,273 owed to SABIS Educational Systems for the 1998 fiscal year. The audited financial statements reported that the school incurred interest charges computed at 10 percent of the unpaid surplus payment and other fees. However, the school's contract with SABIS Educational Systems did not specify the interest rate to be charged by SABIS Educational Systems on unpaid fees owed by the school.

Finding 3. Management contracts executed by five charter schools contained provisions that could restrict public use of educational curricula and other intellectual property developed with public funds.

Two principal objectives of the charter school law are to stimulate the development of innovative programs within public education and to provide models for replication in other public schools.[41] Accordingly, the charter school law prohibits a charter school from charging public schools for use of its educational curricula unless the charter school's contract with a management contractor states otherwise. M.G.L. c. 71, §89(k) states:

> Charter schools shall not charge any public school for the use or replication of any part of their curriculum subject to the prescriptions of any contract between the charter schools and any third party providers.

The charter school law anticipated that the Commissioner of Education would disseminate successful innovations developed by charter schools to other public schools. M.G.L. c. 71, §89(s) states:

> The commissioner shall facilitate the dissemination of successful innovation programs of charter schools and provide technical assistance for other school districts to replicate such programs.

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[41] M.G.L. c. 71, §89(d).

The Office's review identified five contracts between charter schools and management contractors containing intellectual property provisions that would restrict use by other public schools of educational programs or materials developed with public funds by a charter school. Four of the five contracts contained no provisions allowing for use or replication of the educational programs or materials at no charge by other public schools in Massachusetts. The fifth contract required the management contractor to license its educational program and curriculum model at no charge to the local school district. The provisions discussed below could reduce the likelihood that materials developed under these contracts will be replicated by other public schools. DOE records show that the DOE instructed one of the five schools to change the restrictive intellectual property provision before executing the final contract, but the school did not do so.

Boston Renaissance Charter School

The Boston Renaissance Charter School contracted with The Edison Project, LP in April 1995 for comprehensive educational and administrative services, including an educational and instructional program; personnel functions; professional development for all principals and instructional personnel; extra-and co-curricular activities and programs; selection and procurement of instructional materials, equipment and supplies; operation and maintenance of school facilities; and business administration of the school. The contract provided that The Edison Project would own all rights to materials developed by or under the direction of The Edison Project employees, and that The Edison Project would receive one-third of any profits from the sale or licensing of materials developed by any school employee:

> The Board agrees that Edison shall own all copyright and other proprietary rights to all instructional materials, training materials, curriculum and lesson plans, and any other materials developed by Edison, its employees, agents or subcontractors, and to the extent permitted by law, any person working under Edison's direction pursuant to this Agreement. During the term of this Agreement, Edison may disclose such proprietary information, including that which is currently in existence as well as that which may be created in the future. In the future, should Edison develop any information or material for use in the School which Edison considers

> to be proprietary, Edison shall disclose such fact to the Board. The Board shall then have the right and opportunity to object to Edison's identification of the information as proprietary. . . .
>
> Notwithstanding any other provision of this Article, any educational product or service developed exclusively by any employee of the School during the term of this Agreement shall be the joint property of the School, the employee and Edison, and profits from the sale or licensing of that product or service shall be shared in by the School, the Employee and Edison on the basis of one-third of such profits to Edison, one-third of such profits to the School, and one-third of such profits to the employee.

DOE documents included a lengthy letter dated January 1995 from the EOE's General Counsel to the school's attorney, critiquing the draft contract between the school and The Edison Project. Regarding the provision governing proprietary information, the General Counsel's letter instructed the school to include language requiring The Edison Project to give prior notice to the Board of Trustees of any intellectual property it intended to utilize in the charter school. As the above excerpt indicates, the school did include such language.

Chelmsford Public Charter School

The original 1996 contract between the Chelmsford Public Charter School and The Alternative Public Schools, Inc. contained no provision governing rights to intellectual property. However, the amended 1998 contract contained a new provision that gave Beacon Education Management sole ownership of all documents, ideas, or other information developed under the contract with the school:

> CPCS [Chelmsford Public Charter School] agrees that any and all information, whether written or oral, regarding BEACON, its concepts, ideas and proposals, including without limitation all operating procedures, curriculum models, manuals, reports, documents and all other writings and graphic records to the extent not part of the public domain (collectively, "the Information"), to which CPCS has access during the term of this Agreement shall be held and treated by CPCS in the utmost and strictest confidence, and shall not, without BEACON's prior written consent, be disclosed to any other person or entity by CPCS. **CPCS agrees that the Information, including without limitation all BEACON's concepts, ideas, documents and confidential information developed by BEACON or its employees in connection with BEACON's**

> **implementation of this Agreement, shall remain the sole and absolute property of BEACON.** CPCS also agrees that it will not appropriate any of the Information for its own or any other use outside the scope of this Agreement. [Emphasis added.]

Unlike the other contracts discussed in this finding, however, the contract required Beacon Education Management to license the school's educational program to the Chelmsford Public Schools at no charge:

> Beacon agrees that, upon written request of the Trustees, **Beacon shall license, on a non-exclusive basis, the School's curriculum model and educational program at no cost (except the cost of photocopying, printing, etc.) to the Chelmsford Public School System solely for use within the Chelmsford Public Schools**. This license shall be in a form reasonably acceptable to Beacon so as to protect Beacon's property rights as stipulated herein above, to the material licensed thereunder. In addition, the Trustees and Beacon may mutually agree in writing in the future to provide the School's curriculum model and educational program to other parties who have assisted in developing the School. [Emphasis added.]

SABIS International Charter School

The 1995 contract between the school and SABIS Educational Systems provided that SABIS Educational Systems would own only those "trademarks, copyright and other proprietary rights developed prior to the effective date of this Agreement," and that the school and SABIS Educational Systems would jointly own proprietary rights to intellectual property developed for the school with contract funds:

> **Jointly Developed Proprietary Information.** The School and [SABIS Educational Systems] shall jointly own proprietary rights to intellectual property developed for the School using funds provided through this Agreement. The School and [SABIS Educational Systems] agree to establish policies and agreements, consistent with the Act and other laws, for the control, license and release of such intellectual property and for the recognition of the role of teachers and other employees involved in the development of such intellectual property. The parties shall act in good faith to permit licensing of proprietary information covered by this Paragraph 7.3 in accord with the provisions of 601 CMR 1.05(1). [Emphasis in the original.]

DOE records included a draft version of the contract containing a provision stating that SABIS Educational Systems would own all trademark, copyright, and other proprietary rights to any materials developed by SABIS Educational Systems during the contract term. In a July 1995 letter to the school's attorney, the EOE's General Counsel instructed the school to change this provision, and the school did so. As the above excerpt indicates, the final version of the contract required joint ownership by SABIS Educational Systems and the school of the proprietary rights.

Seven Hills Charter School

The 1996 contract between the Seven Hills Charter School and The Edison Project provided that The Edison Project would own the rights to all materials developed by its employees or any school employee supervised by The Edison Project:

> The Board agrees that Edison shall own all copyright and other proprietary rights to all instructional materials, training materials, curriculum and lesson plans, and any other materials developed by Edison, its employees, agents or subcontractors, or by any individual including Board employees working for, or supervised by Edison which is developed during working hours, or during the time for which the individual is being paid, or with Edison's assistance. Except as otherwise provided herein, Edison shall have the sole and exclusive right to license such materials for use by other schools, school districts or customers, or to modify and/or sell such material to other schools, school districts or customers.

The contract also provided that The Edison Project would receive one-third of any profits from the sale or licensing of materials developed by any school employee:

> Notwithstanding any other provision of this Article, any educational product or service developed solely by any employee of the School shall be the joint property of the School, the employee and Edison, and profits from the sale or licensing of that product or service shall be shared in by the School, the Employee and Edison on the basis of one-third of such profits to Edison, one-third of such profits to the School, and one-third of such profits to the employee.

Internal DOE memoranda show that two DOE officials raised concerns about the latter provision before the DOE approved the contract. In September 1996, the DOE Assistant Commissioner wrote in an internal memorandum:

> As with Sabis, I believe anything developed with public money by a public entity is in the public domain and cannot be controlled, licensed, or otherwise be claimed as proprietary. This does not apply to what Edison may have developed privately on its own nickel. But this graph [*sic*] suggests that anything developed at the Seven Hills Charter School with public money becomes proprietary, which is false. [Emphasis in the original.]

In a January 1997 internal memorandum, a DOE attorney also raised concerns about this contract provision but noted that the DOE had already approved a charter school contract with The Edison Project containing a similar provision:

> I do still have a concern about Article XI (page 24), "Proprietary Information." My concern is that a strict reading of this section could fly in the face of one of the purposes of charter schools by eliminating the possibility that the successes of this program cannot be replicated without access to the curricular materials that could fall under this section. **However, since this language is almost identical to that in the Renaissance Charter School's agreement with the Edison Project, I do not believe that this is an issue that we could raise at this point.** In addition, it may be that I am overly cautious about this and this will never become an issue. [Emphasis added.]

DOE records contained no evidence that the DOE communicated these concerns to the school, nor did DOE records contain any letter from the DOE approving the final contract before it was executed. In an interview with the Office, the Acting Associate Commissioner of the DOE's charter school office stated that, notwithstanding the concerns raised by the DOE attorney in 1997, the DOE's approval decisions regarding the terms of educational management contracts are not and should not be governed by its past decisions regarding similar contracts.

Somerville Charter School

The October 1996 contract between the Somerville Charter School and SABIS Educational Systems contained the following provisions, the wording of which was nearly identical to the wording of the contract between the SABIS International Charter School and SABIS Educational Systems:

> **JOINTLY DEVELOPED PROPRIETARY INFORMATION.** The School and SABIS shall jointly own proprietary rights to intellectual property developed for the School using funds provided through this Agreement. The School and SABIS agree to establish policies and agreements, consistent with the Act and other laws, for the control, license and release of such intellectual property and for the recognition of the role of teachers and other employees involved in the development of such intellectual property. The parties shall act in good faith to permit licensing of proprietary information covered by this Paragraph 7.3 in accord with the provisions of 601 CMR 1.05(1). [Emphasis in the original.]

In September 1996, one month before the contract was executed, the DOE Associate Commissioner sent a letter to a Co-Chair of the Somerville Charter School Board of Trustees regarding the school's draft contract with SABIS Educational Systems, which contained the provisions reproduced above. The Associate Commissioner's letter to the school listed required revisions to the draft contract, including the following objection to the draft contract provision labeled "Jointly Developed Proprietary Information":

> Anything developed with public money by a public entity is in the public domain and cannot be controlled, licensed, or otherwise be claimed as proprietary. This has nothing to do with what Sabis may have developed privately on its own nickel. But this paragraph seems to suggest that anything developed at the Somerville Charter School <u>with</u> public money become[s] proprietary, which is false. [Emphasis in the original.]

However, the school did not amend this provision in response to the Associate Commissioner's letter. The final contract language was identical to the draft contract language.

Finding 4. The DOE's management contract approval process has been unsystematic and inconsistently implemented.

Under the charter school law, the Board of Education must approve the terms of any contract between a charter school and a private entity if the charter school intends to procure substantially all educational services from that entity. The charter school law contains no standards or criteria for the Board's approval of contract terms, nor does it specify the conditions under which approval may be denied.

The Office's review of DOE documents pertaining to the DOE's review and evaluation of the terms of such contracts indicated that the DOE did not adopt formal criteria for approval of these contracts until 1998.[42] In contract approval letters issued in 1998 and 1999 to the Chairs of the Boards of Trustees of three charter schools not included in the scope of this review, the Commissioner of Education summarized the Board's contract approval criteria as follows:

> We have determined that the contract is consistent with the charter school statute and regulations. We have also determined that the contract meets the criteria for my approval: the contract assures that the Board of Trustees will operate independently of any other parties involved with management of the charter school; it uses clear criteria for the evaluation of the contractor; and, it includes sensible provisions for the termination of the contract.

DOE records showed that between January 1995 and July 1998, the DOE (or the EOE, its predecessor agency) reviewed draft versions of the five educational service contracts executed by schools in this review. The DOE or the EOE sent letters to the schools containing recommended revisions to four of the five contracts. However, DOE records contained no letters or other documentation confirming that the Board of Education had approved these contracts. In the case of the fifth contract, DOE records contained no correspondence from the DOE to the school.

In an interview with the Office, the DOE's Acting Associate Commissioner acknowledged that the DOE should improve its contract approval procedures. He stated that the DOE plans to solicit all final educational service contracts and contract amendments from existing charter schools in order to ensure that the DOE's files are complete and accurate and that the DOE has issued final approval letters for all approved contracts. He noted that the charter school office is empowered to withhold quarterly payments from schools that do not comply with the DOE's instructions to

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[42] The Office's review of four educational service contracts executed in 1998 and 1999 by schools that were not in the scope of this review showed that the DOE Commissioner approved these contracts on behalf of the Board of Education.

change the terms of draft educational services contracts as a condition of DOE approval, or that execute final educational services contracts without DOE approval.

Boston Renaissance Charter School

DOE records indicated that the school incorporated most of the revisions recommended in January 1995 by the EOE into its final contract with The Edison Project; however, DOE records contained no final approval letter from the DOE to the school.

Chelmsford Public Charter School

The Chelmsford Public Charter School submitted a draft of its revised management contract to the DOE for comment in January 1998.[43] DOE records contained no evidence of any DOE action in response to the draft contract over the ensuing months. The school then sent a newly signed version of the contract to the DOE in June 1998. In a July 1998 letter to the Chairman of the school's Board of Trustees, the DOE's Associate Commissioner posed several questions and suggested that a new provision be added regarding evaluation of student educational outcomes (as discussed in the previous Finding 1). As noted earlier, the school did not include the suggested provision in the final contract with Beacon Education Management. DOE records contained no further correspondence or final approval letter from the DOE to the school.

SABIS International Charter School

The SABIS International Charter School received a conditional approval letter from the Secretary of Education in April 1995 stating, in part:

> [T]his approval is conditioned on the filing of an amended 95/96 operating budget for the charter school, clarifying the fee for services and the license fee for [SABIS Educational Systems, Inc.].

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[43] The EOE approved the original contract between the Chelmsford Public Charter School and The Alternative Public Schools, Inc. in June 1996. As noted earlier, the revised version of the 1996 contract included new provisions and changed the contractor's name to "Beacon Education Management LLC."

This amended operating budget was attached to the final contract between the school and SABIS Educational Systems, but it was not contained in DOE records pertaining to the contract. Although DOE records showed that the school incorporated most of the revisions recommended by the DOE into its final contract with SABIS Educational Systems, DOE records contained no final approval letter from the DOE to the school.

Seven Hills Charter School

DOE records contained a copy of the signed contract between the school and The Edison Project. However, although DOE records contained several internal memoranda raising concerns about the contract (as discussed in the previous Finding 2), DOE records contained no correspondence from the DOE to the school regarding the draft contract, nor did they contain a final approval letter from the DOE to the school.

Somerville Charter School

DOE records showed that the school's final contract with SABIS Educational Systems did not incorporate all of the contract revisions required by the DOE as a condition of DOE approval. In a September 1996 letter to the Co-Chair of the Board of Trustees, the DOE's Associate Commissioner listed eight contract revisions required as a condition of contract approval. The school's executed management contract incorporated four of the eight revisions.

Two of the four revisions required by the DOE but not incorporated into the final contract were technical changes for clarification. However, the other two required revisions were substantive. As previously noted, the DOE's Associate Commissioner objected to the draft contract provision giving SABIS Educational Systems joint ownership of the rights to educational programs or other intellectual property developed by the school with public funds; nevertheless, this draft contract provision was incorporated into the final contract. The DOE's Associate Commissioner also instructed the school to amend the draft contract provision specifying the conditions under which the school could terminate the contract with SABIS Educational Systems, but the school did not do so.

III. Conflict of Interest Issues

Background

Charter schools are subject to the Massachusetts conflict of interest law, M.G.L. c. 268A, which regulates the conduct of public officials and employees at all levels of government in Massachusetts. The purpose of the conflict of interest law is to ensure that public officials' financial interests and personal relationships do not conflict with their public obligations.[44] Under the charter school law, charter schools are deemed state agencies for the purposes of M.G.L. c. 268A.[45] Any individual who holds an office, position, or employment with a charter school, whether paid, unpaid, full-time, or part-time, is considered a state employee under the conflict of interest law. Individuals serving as consultants to charter schools are also covered by the law in most cases.

M.G.L. c. 268A, §6 prohibits a state employee from participating in an official capacity in any particular matter that would affect the financial interest of a business organization in which the employee is serving as officer, director, trustee, partner, or employee unless the employee receives permission from the public official who appointed the employee to his or her job. According to the *Guide to the Conflict of Interest Law for State Employees* published by the State Ethics Commission, which enforces the conflict of interest law, state employees must take the following steps in order to receive the necessary permission:

> To receive the exemption, the employees must first advise their appointing official of the particular matter in which they normally would participate as part of their job and make full disclosure of the financial interest involved. A copy of this statement must be sent to the Ethics Commission. The appointing official may then decide to assign the matter to another person or allow the employee to participate. A determination to allow the employee to participate must be in writing and filed with the Ethics Commission.

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[44] The summary of the conflict of interest law provided in this section is drawn from *A Practical Guide to the Conflict of Interest Law and Financial Disclosure Law for State Employees* published by the State Ethics Commission.

[45] M.G.L. c. 71 §89 (v).

The State Ethics Commission is authorized to impose civil files of up to $2,000 for each violation of the law and to recover damages. The law also carries criminal penalties, including fines and terms of imprisonment.

Elected and certain appointed state officials are required under M.G.L. c. 268B, the financial disclosure law, to file annual statements of financial interest reporting their financial activities of the previous year, including their income, business ownership and equity, real property owned in Massachusetts, securities and investments, and certain information pertaining to their family members, with the State Ethics Commission. Until 1998, the charter school law required members of the boards of trustees of all charter schools to file statements of financial interest pursuant to M.G.L. c. 268B, §5. However, in April 1998 the charter school law was amended to reduce these disclosure requirements for charter school trustees. The amended disclosure language stated:

> Members of boards of trustees of charter schools operating under the provisions of this section shall file a disclosure annually with the state ethics commission, the department of education, and the city or town clerk wherein such charter school is located. The form of the disclosure shall be prescribed by the ethics commission and shall be signed under penalty of perjury. Such form shall be limited to a statement in which members of the board of trustees shall disclose any financial interest that they or a member of their immediate families, as defined in section 1 of said chapter 268A, have in any charter school located in the commonwealth or in any other state or with any person doing business with any charter school.[46]

Under the charter school law, the members of a charter school's board of trustees are "public agents authorized by the commonwealth to supervise and control the charter school."[47] As board members, charter school trustees are required to fulfill certain fiduciary obligations or duties that apply to members of all boards of directors, whether their organizations are private or public. These duties are generally referred to as the "duty of care" (sometimes called the duty to be informed) and the "duty of loyalty." The Charter School Legal Memorandum 96-3 issued to charter schools in 1996 by the

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[46] M.G.L. c. 71, §89(v).

[47] M.G.L. c. 71, §89(a).

former EOE provided the following explanation of the obligations of charter school trustees as public agents to fulfill the duty of care and the duty of loyalty:

> The Board of Trustees, as a public agent, is entrusted by the Commonwealth to supervise and control the charter school. Accordingly, the Board of Trustees is primarily responsible for ensuring the charter school's compliance with the charter school legislation.
>
> The Board of Trustees has two primary duties as a public agent: (1) the duty of care, and (2) the duty of loyalty. The duty of care means that each trustee must act with such care as an ordinary prudent person would employ in the trustee's position. This duty imposes on the trustee the responsibility of participating actively in the oversight of the charter school's activities. Such participation includes attending meetings, reviewing the school's code of conduct, financial reports, and other required documents, and monitoring delegated activities. The duty of loyalty means that the trustee must act in good faith and in a manner the trustee reasonably believes is in the best interest of the charter school.

DOE records showed that as of May 1999, 308 trustees – virtually all trustees of the 24 charter schools in this review – had complied with the annual financial disclosure requirement contained in M.G.L. c. 71, §89(v). Of these, approximately three-quarters disclosed no financial interests in any charter schools. The information reported on the disclosure forms showed that some charter school trustees had financial interests that required them to restrict their actions as trustees in order to comply with the conflict of interest law and their duty of loyalty to their charter schools. For example, 29 trustees reported that they were also employed by their schools as teachers or administrators.

Under the charter school law, the Commissioner of Education is the appointing official of members of charter school boards of trustees for purposes of M.G.L. c. 268A, the conflict of interest law. As of May 1999, DOE records contained no disclosures from charter school trustees pursuant to M.G.L. c. 268A, §6, or written determinations by the DOE in response to such disclosures. In interviews, DOE officials confirmed that the DOE had not granted written permission to any charter school trustees to participate in particular matters in which they held financial interests.

Finding 5. The composition of some charter school boards of trustees could undermine the boards' ability to fulfill their fiduciary duties to the schools they serve.

According to annual reports filed with the Commonwealth,[48] some trustees serving on charter school boards simultaneously served on the boards of directors of the non-profit management contractors providing services to those charter schools. In one case, a majority of the school's trustees also served as members of the management contractor's board of directors. These dual board memberships could undermine the interests of both the schools and the non-profit entities contracting with the schools.

A charter school trustee who simultaneously serves on the board of directors of the school's management contractor may have conflicting fiduciary obligations. For example, in deciding and voting on the compensation to be paid to the management contractor by the school, the trustee cannot reasonably exercise the duty of loyalty to both parties to the transaction: the school and the management contractor. The trustee is obligated by the duty of loyalty as well as M.G.L. c. 268A, §6 to abstain from participating in the decision. By doing so, however, the trustee's ability to exercise the duty of care on behalf of the school will be reduced.

A June 1996 legal memorandum from the General Counsel of the former EOE alerted charter schools to the potential for conflicts of interest under this scenario. The General Counsel's memorandum stated, in part:

> In order to avoid conflicts of interest, the Board of Trustees should carefully scrutinize, among other things, its transactions and the financial interests of its members. . . . One example of a conflict of interest is where a member of the educational contractor of the charter school is on the Board of Trustees of the charter school.

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[48] The information on board membership contained in this finding was drawn from annual reports filed with the DOE by charter schools and from annual financial reports filed with the Office of the Attorney General's Division of Public Charities by charitable organizations between 1996 and 1998. The annual financial disclosure requirement contained in M.G.L. c. 71, §89(v) does not require charter school trustees to disclose board memberships in organizations that have financial relationships to the charter schools on whose boards they serve.

A June 1999 resource guide published by the Charter Friends National Network[49] strongly advised charter school boards to maintain complete independence from their management contractors:

> **Independence and integrity of charter school boards.** To ensure the independence and public integrity of charter school governing boards, it is essential that such boards scrupulously maintain complete independence from companies that seek or do business with the school. Conflicts of interest impede accountability by preventing impartial evaluation of the contractor's performance, and threaten the school board's integrity as a guardian of the public trust. For this reason, charter school boards should avoid having members who have financial or familial connections with any current or potential vendor or contractor (or subsidiary or agent of such). Likewise, potential or contracted vendors should not exercise influence in the appointment of charter school board members beyond the initial board formation stage.[50] [Emphasis in the original.]

The Office's review identified dual board memberships in the cases of three schools discussed below. In each case, the school was initiated and founded by the non-profit entity providing administrative services under contract to the school. In each case, the school's Board of Trustees included a substantial number of trustees who also served on the non-profit management contractor's board of directors. Any trustee also serving on the board of the school's management contractor who has participated in any charter school decision or action affecting the management contractor's financial interests could have violated his or her duty of loyalty to the charter school as well as the conflict of interest law. Where a majority of trustees are prohibited by their duty of loyalty and the conflict of interest law from participating in certain financial decisions affecting the school, as in one case discussed below, the decision-making capacity of the Board of Trustees may be significantly compromised.

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[49] The Charter Friends National Network, based in St. Paul, Minnesota, was created in 1997 to promote quality charter schools by supporting state-level charter school organizations.

[50] Margaret Lin and Bryan Hassel, *Charting a Clear Course* (Charter Friends National Network, 1999), 16.

Community Day Charter School

Reports filed by the school and its management contractor for 1997 and 1998 indicated that five of 11 trustees of the Community Day Charter School also served on the Board of Directors of Community Day Care Center, Inc. (CDCC), the school's management contractor, during this period. The school contracted with CDCC for accounting, bookkeeping, and other administrative services.

Lawrence Family Development Charter School

Reports filed by the school and its management contractor for 1997 and 1998 indicated that six of 13 trustees of the Lawrence Family Development Charter School, including the President and Treasurer, also served on the Board of Directors of Lawrence Family Development and Education Fund, Inc. (LFDEF) during this period. The school contracted with LFDEF for accounting, bookkeeping, and other administrative services.

Neighborhood House Charter School

Reports filed by the school and its management contractor for 1997 and 1998 indicated that 18 of 20 trustees of the Neighborhood House Charter School also served on the Board of Federated Dorchester Neighborhood Houses, Inc. (FDNH) in 1997, and that 12 of 13 school trustees served on the Board of Directors of FDNH in 1998. The school contracted with FDNH to perform all administrative functions of the school, including payroll, bookkeeping, budget preparation, and delivery of food and transportation services.

Finding 6. The DOE has provided no guidance to charter schools concerning the requirements of the conflict of interest law.

The Office's review of written material distributed to charter schools by the DOE indicated that the DOE has not provided information to charter schools on the requirements of the conflict of interest law and their obligations under the conflict of

interest law.[51] If school trustees and employees are unaware of the legal prohibition on their ability to participate in matters in which they have a financial interest, the risk of unintentional violations of the law is significant. Under these circumstances, the law is not and cannot be an effective safeguard or deterrent against conflicts of interest.

In an interview, DOE officials of the charter school office acknowledged that they are unfamiliar with the detailed requirements of M.G.L. c. 268A as they apply to charter schools. They stated that the charter school office plans to consult with the DOE's legal office and the State Ethics Commission in order to provide guidance to charter schools regarding their obligations under the conflict of interest law.

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[51] The 1997 *Massachusetts Charter School Handbook* distributed to charter schools by the Pioneer Institute for Public Policy Research provided a brief description of the conflict of interest law as it applies to charter school trustees and advised charter schools to contact the DOE with any questions regarding conflict of interest or ethics issues.

IV. Loans

Background

Most public schools in Massachusetts are subject to stringent borrowing rules. Long-term borrowing by cities and towns, such as bond issuances, requires formal approval by a two-thirds vote of Town Meeting or the City Council. The law also restricts the maximum amount of debt for certain purposes that local governments may assume at one time.[52] Local governments may incur temporary debt in anticipation of revenue or reimbursement by the Commonwealth. However, temporary borrowing is subject to restrictions on the amount borrowed and the repayment period, as well as approval and disclosure requirements.[53]

Charter schools are not subject to these borrowing restrictions. Under the charter school law, charter schools may incur temporary debt in anticipation of receiving funds, provided that the terms of repayment may not exceed the duration of the charter without the approval of the Board of Education.[54] There are no restrictions on the purposes for which charter schools may borrow funds or the amount of funds charter schools may borrow, nor are the terms of charter school loans subject to any specific approval or disclosure requirements.

According to the 1998 audited financial statements of the 24 charter schools in this review, 12 schools had available credit lines, with borrowing limits ranging from $50,000 to $750,000, to fund their operations in anticipation of state revenues. Nine of the 12 schools had credit lines with banks; the other three schools had credit lines with their management contractors. Only one school – Hilltown Cooperative Charter School – had an outstanding balance on its credit line as of June 30, 1998.

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[52] M.G.L. c. 44, §7.

[53] M.G.L. c. 44, §§4, 6A.

[54] M.G.L. c. 71, §89(j)(6).

The audited financial statements showed that a total of 10 of the 24 schools had outstanding loans and other financial obligations – such as overdue fees and interest charges owed to management contractors – at the close of the 1998 fiscal year. Table 3 lists these outstanding balances by school. As the table shows, the total outstanding balances included approximately $12.3 million owed by Boston Renaissance Charter School, approximately $6 million owed by Seven Hills Charter School, and smaller amounts owed by Boston University Residential Charter School, Cape Cod Charter School, Hilltown Cooperative Charter School, Lynn Community Charter School, Neighborhood House Charter School, SABIS International Charter School, Somerville Charter School, and South Shore Charter School.

The audited financial statements reported that some loans – including the largest loans to the Boston Renaissance Charter School[55] and the Seven Hills Charter School – financed renovations and other improvements to charter school facilities. The audited financial statements of three schools with outstanding loans – Boston University Residential Charter School, SABIS International Charter School, and Somerville Charter School – indicated that each school had used some loan proceeds to fund some of the school's operating expenses. The other schools' audited financial statements did not report the purposes of the loans.

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[55] In 1995, the Commonwealth's Asset Management Board approved the noncompetitive lease of a vacant 13-story state building to the Boston Renaissance Charter School for nine years and four months. Also in 1995, the Government Land Bank (GLB) loaned the school $12.2 million for renovations to the building. The Board's approval was conditional on the GLB's guarantee of both the rental payments and the building improvements.

Table 3. Charter School Outstanding Loans And Management Contract Charges as of June 30, 1998

School	Lender	Amount Owed	
Boston Renaissance	The Edison Project, Inc.	$107,000	
	The Edison Project, Inc.	244,183	
	Massachusetts Government Land Bank	11,944,523	
			$12,295,706
Boston University Residential	Boston University	370,839	
	US Trust*	200,000	
			570,839
Cape Cod	Cape Cod Bank & Trust Company		80,809
Hilltown Cooperative	Cooperative Fund of New England		17,443
Lynn Community	unspecified lender		58,983
Neighborhood House	Federated Dorchester Neighborhood Houses, Inc.		221,794
SABIS International	SABIS Educational Systems, Inc.		967,095
Seven Hills	The Edison Project, L.P.	1,346,747	
	The Edison Project, L.P.**	686,519	
	unspecified bank	3,995,000	
			6,028,266
Somerville	SABIS Educational Systems, Inc.		1,139,232
South Shore	unspecified lender	30,000	
	unspecified bank	125,000	
			155,000

Source: Charter school audited financial statements for the 1996, 1997, and 1998 fiscal years.

* This obligation was subsequently assumed by the Carlisle Foundation, according to the school's 1998 audited financial statements.

** The school was jointly liable with Seven Hills Charter School, Inc. for this obligation, according to the school's 1998 audited financial statements.

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Finding 7. Loan agreements between charter schools and their management contractors could render the schools excessively dependent on their management contractors while reducing the schools' contracting leverage.

According to their 1998 audited financial statements, five charter schools owed a total of $3,365,823 to their management contractors as of June 30, 1998. In four of the five cases, the management contractors loaning funds to the schools were private, for-profit companies providing educational and administrative services under contract to the schools. This arrangement increases the schools' dependence on their management contractors. To the extent that a school is in debt to its management contractor, the school's leverage to enforce the management contract, negotiate changes to the contract, or terminate the contract is likely to be correspondingly reduced. Moreover, a management contractor that administers and oversees a school's financial operations and also loans money to that school has a potential conflict of interest, especially if the management contractor is involved in deciding whether and how much money the school should borrow.[56]

The DOE's 1998 publication, *The Massachusetts Charter School Initiative*, noted that contracting with for-profit companies was a means of generating charter school financing:

> Companies can offer communities educational expertise, provide access to capital, and infuse significant private sector funds into public schools. Where a Board of Trustees has hired a private company to manage the school and achieve the goals of the charter, it can easily terminate the contract if the Board isn't satisfied with the company's performance.

The assumption that a school can "easily" terminate a contract with a company that has loaned the school substantial funds – or, as in one case discussed below, has

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[56] In response to a draft version of this report, the DOE Commissioner stated that charter schools receive no start-up funds aside from a small federal start-up grant and, thus, may have little choice but to assume debt in order to finance their first years of operation. He also stated that the difficulty of obtaining conventional bank loans leaves some charter schools with few or no viable alternatives to borrowing funds from their management contractors.

guaranteed the school's loan from another financial institution – is questionable. A summary of the five schools' financial obligations to their management contractors is provided below.

Boston Renaissance Charter School

According to the school's 1998 audited financial statements, the school borrowed $457,000 from its management contractor, The Edison Project: $350,000 to finance installation of air conditioning, and $107,000 to repay The Edison Project for certain school wiring costs. The first loan was payable over three years at a 9.41 percent interest; the second loan was payable in equal monthly installments of $7,000 at a zero percent interest rate. As of June 1998, the school's outstanding obligations to The Edison Project totaled $351,183.

Neighborhood House Charter School

The school's 1998 audited financial statements reported that the school owed $221,794 to its management contractor, Federated Dorchester Neighborhood Houses, Inc. (FDNH) as of June 1998. The school's indebtedness to FDNH included unpaid management fees as well as other unspecified financial obligations. The audited financial statements provided no information on the amount of the unpaid fees or the terms and conditions of the school's other financial obligations to FDNH.

SABIS International Charter School

According to the school's 1998 audited financial statements, the school owed $967,095 to SABIS Educational Systems as of June 1998. This indebtedness included unpaid management fees and interest charges as well as other financial obligations to SABIS Educational Systems. The 1998 audited financial statements show that the school deferred payment until the 1998 fiscal year of $252,020 in charges owed to SABIS Educational Systems for the 1997 fiscal year, and that the school deferred payment of $651,177 in charges owed to SABIS Educational Systems for the 1998 fiscal year.

In a December 1998 letter to the Board of Trustees, the school's independent auditor noted the lack of a written loan agreement specifying the terms and conditions of the school's financial obligations to SABIS Educational Systems. The letter stated, in part:

> The School frequently borrows and repays funds to SABIS Educational Systems, Inc., the management company. We recommend the development of a written agreement between the School and SABIS Educational Systems, Inc. to formally define the terms and conditions of the loan in order to avoid misunderstandings.

Seven Hills Charter School

According to the school's 1998 audited financial statements,[57] the school owed its management contractor, The Edison Project, $1,346,747 in unspecified charges as of June 30, 1998. The audited financial statements also reported that the school was jointly liable with Seven Hills Charter School, Inc., the private non-profit corporation established to support the school, for a $686,519 loan at an 8.8 percent interest rate. In addition, the audited financial statements reported that The Edison Project had guaranteed a $4,047,000, five-year bank term loan to the school and Seven Hills Charter School, Inc. for renovation and construction work, and that the loan will require a balloon payment of $3,722,333 in the 2003 fiscal year. After the final payment on the bank term loan has been made, The Edison Project's $686,519 loan will become fully due.

Somerville Charter School

According to the school's 1998 audited financial statements, the school owed $1,139,232 to SABIS Educational Systems as of June 1998. This amount included unpaid management fees as well as other financial obligations. In both 1997 and 1998,

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[57] It is noted that the Independent Auditor's Report on Primary Government Financial Statements contained the following statement: "[T]he primary government financial statements, because they do not include the financial data of component units [Seven Hills Charter School, Inc.] of Seven Hills Charter School, as discussed in Note 2, do not purport to, and do not, present fairly the financial position of Seven Hills Charter School as of June 30, 1998, and the results of its operations for the year then ended in conformity with generally accepted accounting principles."

the school's independent auditor sent letters to the Board of Trustees raising concerns about the lack of a written loan agreement specifying the terms and conditions of the school's frequent borrowing and repayment of funds to SABIS Educational Systems.

Finding 8. State taxpayers could be liable for unpaid debts of charter schools that lose their charters.

The charter school law does not address the question of what party or parties would be liable for a charter school's outstanding financial obligations in the event that:

- the Commonwealth revoked the school's charter before the charter expiration date, or
- the school had not satisfied its obligations by the charter expiration date.

It is the opinion of the Office that state taxpayers could under some circumstances be held legally responsible for charter schools' unpaid debts. If the current cap of 37 Commonwealth charter schools is increased or removed, the outstanding financial obligations of Massachusetts charter schools will also be likely to rise, along with the financial exposure of state taxpayers. Mitigating the risks of this exposure will require effective, proactive monitoring and oversight by the DOE.[58]

[58] In response to a draft version of this report, the DOE Commissioner stated: "[W]e agree that the Department of Education must continue to ensure that the risk of financial exposure to the Commonwealth is mitigated by monitoring and oversight of the financial obligations incurred by charter schools."

V. Financial Management and Oversight

Background

The Massachusetts charter school initiative has defined three performance measures by which charter schools are to be evaluated and held accountable: academic program success, organizational viability, and adherence to the school charter. Financial management is a key component of a charter school's organizational viability. According to the DOE, organizational viability means that:

> the school is financially solvent and stable, enrollment is stable and near capacity, school governance is sound, and professional staff are competent and resourceful.[59]

The DOE's charter school regulations require a charter school applicant to demonstrate its ability to achieve fiscal and operational viability within the five-year charter term in order to obtain charter approval.[60] The Board of Education may revoke a charter for financial insolvency.[61]

DOE regulations also require a charter school seeking renewal of its charter to demonstrate its financial viability.[62] The DOE's charter renewal application for the 1998-99 school year required the applicant to answer the following question: "Is the school financially solvent and stable?" The renewal application provided the following guidance to the charter renewal applicant:

> What reviewers will look for:
>
> A clear, concise narrative statement that provides sufficient evidence that the school has competently and effectively managed its finances. The statement should address any negative findings from independent audits

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[59] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 4.

[60] 603 CMR 1.05.

[61] 603 CMR 1.12.

[62] 603 CMR 1.11.

and/or budget deficits in a fiscal year, and how the school responded to either.

Suggested sources of evidence:

Results from independent financial audits, financial statements.

In July 1998, the DOE issued Charter School Technical Advisory 98-1, which advised charter schools that they were required to follow sound business practices and generally accepted government auditing standards as conditions of their charters. The Technical Advisory outlined three essential elements of sound business practices:

- a documented system of internal controls;
- a documented procurement process that promotes competition, fairness, and best value contracting; and
- written policies and procedures ensuring that the school's procurement process is consistent with and based upon its internal control system and requiring sufficient record-keeping for audit purposes.[63]

The Office's review disclosed weaknesses in the financial management of some charter schools and in the DOE's oversight of charter schools' financial operations. These weaknesses undermine the accountability of the charter school initiative and increase the financial risks to state taxpayers. These weaknesses are summarized in the findings that follow.

Finding 9. The lack of uniformity of the audited financial statements submitted to the DOE by charter schools reduces their usefulness as a financial monitoring tool.

The charter school law requires charter schools to keep accurate financial records and to obtain an independent audit each year.[64] The DOE's charter school regulations require the independent audit to be "consistent with generally accepted auditing

[63] The following section of this report provides a detailed discussion of charter school procurement policies and procedures.

[64] M.G.L. c. 71, §89(hh).

principles" and "consistent with any guidelines the Department of Education may issue."[65]

The charter school law also requires the independent audits obtained by the schools to be in a form prescribed by the State Auditor.[66] In October 1998, the State Auditor issued a *Report on Establishing Standardized Accounting and Reporting Methods for Massachusetts Charter Schools*. The Auditor's report found that the format of the financial information being provided by charter schools to the DOE was inconsistent and that this lack of uniformity limited the usefulness of the financial information. To address this deficiency, the Auditor's report provided a basic chart of accounts, pro forma budgets, and financial reports for use by charter schools in addition to the financial reports required by generally accepted accounting principles (GAAP).[67] The Auditor's report recommended that certain charter schools modify the recommended chart of accounts as necessary to accommodate their unique operational situations.

The Auditor's report also recommended that the DOE amend its regulations to require Massachusetts charter schools to maintain their financial records in accordance with GAAP and that the independent audits of charter schools be performed in accordance with generally accepted government auditing standards (GAGAS) issued by the U.S. Comptroller General. The GAGAS include all generally accepted auditing standards as well as numerous additional standards requiring higher levels of audit reporting, follow-up, documentation, and distribution. Finally, the Auditor's report recommended that the audits comply, if appropriate, with the requirements of Circular A-133, issued by the U.S. Office of Management and Budget, which sets forth standards of consistency and uniformity for federal agency audits of states, local governments, and non-profit organizations spending federal funds.

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[65] 603 CMR 1.08.

[66] M.G.L. c. 71, §89(ll).

[67] GAAP are uniform minimum standards of and guidelines for financial accounting and reporting. The audited financial statements of two of the 24 schools in this review stated that the schools did not maintain their financial records in accordance with GAAP.

The Office's review confirmed the State Auditor's finding regarding the lack of a uniform format for the financial information reported by charter schools. For example, the Office noted that the accounting standards used to prepare the audited financial statements were not uniform among the 24 charter schools in this review. Some audited financial statements included cash flow statements;[68] others did not. Some applied a modified accrual basis of accounting; others adopted a full accrual basis. In addition, the loan information provided by the independent auditors varied: some auditors provided detailed information on outstanding loan balances, interest rates, and repayment schedules, whereas others provided no detailed information. Without this information, the DOE cannot reasonably evaluate a school's capacity to meet its outstanding financial obligations within the term of its charter.

In an interview, DOE officials advised the Office that charter schools have been instructed to adopt the chart of accounts recommended by the State Auditor for their audited financial statements for the 2000 fiscal year and will be given further guidance regarding compliance with the other financial reporting forms and recommendations contained in the State Auditor's report.

Finding 10. Three charter schools exhibited warning signs of financial problems that, if uncorrected, could jeopardize their future viability.

There are multiple measures that can be used to evaluate an organization's financial condition. In general, the organization's performance with respect to a single measure at a single point in time is less significant than the pattern of financial management the organization exhibits over time. Thus, effective financial oversight requires expert examination of trends reflecting an organization's performance with respect to multiple financial measures over time.

Based on the incomplete information contained in the audited financial statements, the Office identified three charter schools whose financial condition exhibited several warning signs; these schools are discussed below. While warning signs do not necessarily mean that the organization cannot remain viable, they do suggest a need

[68] A cash flow statement accounts for all sources and uses of cash.

for increased vigilance and oversight to ensure that the problematic financial trends do not threaten the organization's future viability.

Boston University Residential Charter School[69]

A widely used measure of an organization's ability to meet its financial obligations is the "current ratio," which is computed by dividing an organization's current assets by its current liabilities. For charter schools, current assets consist of cash and other assets (such as receivables) that are expected to be converted to cash, sold, or used within one year.[70] Current liabilities are obligations that are expected to require use of current assets, such as salaries, fees, and lease payments.[71] A current ratio of less than 1 indicates that an organization cannot readily cover its current financial obligations by liquidating its assets. According to the school's audited financial statements covering the period of March 1, 1997 – the school's inception – to June 30, 1998, the school's current ratio as of June 30, 1998 was only .18.[72]

The December 1998 independent auditor's report accompanying the audited financial statements noted that the school's expenditures had exceeded its revenues by $556,133 and questioned the school's financial viability:

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[69] Unlike the other charter schools reviewed by the Office, the Boston University Residential Charter School provides residential care in addition to education for youths referred through the Division of Youth Services and the Department of Social Services.

[70] The Financial Accounting Standards Board (FASB) *Accounting Standards* (1994/95 Edition, 4487) define current assets as those assets that "are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." The FASB is an authoritative body that establishes generally accepted accounting principles.

[71] The FASB *Standards* (4487) define current liabilities as "obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets or the creation of other current liabilities."

[72] In reviewing the current ratios of the schools in this review, the Office noted that less than half of the schools classified assets and liabilities as current and noncurrent in their audited financial statements, as defined by Accounting Research Bulletin No. 43, Chapter 3A, "Working Capital – Current Assets and Current Liabilities."

> As discussed in Note 7 to the financial statements, the School incurred a decrease in net assets of $556,133 for its initial period ended June 30, 1998 and is dependent on advances from Boston University, **which raises substantial doubt about the School's ability to continue as a going concern.** [Emphasis added.]

The audited financial statements reported that the school's management was initiating several steps to increase revenue available to the school. These steps included seeking an increase in the school's negotiated daily rate charged to state agencies placing students at the school, launching a major fundraising effort, and developing a more focused approach to recruiting placements from state agencies.

According to the DOE's Acting Associate Commissioner, the DOE conducted regular meetings with the school during the first half of 1999 to address the issue of the school's financial viability. He stated that the school was aware that the DOE would be obligated to revoke its charter if the school proved unable to demonstrate its future viability.

SABIS International Charter School

Between June 30, 1997 and June 30, 1998, the school's current ratio dropped from 1.32 to .74, according to the school's audited financial statements. The 1998 audited financial statements also showed that the school's outstanding financial obligations to its management contractor, SABIS Educational Systems, increased from $375,650 at the end of the 1997 fiscal year to $967,095 at the end of the 1998 fiscal year. As discussed earlier in this report, the audited financial statements showed that the school deferred payment until the 1998 fiscal year of $252,020 in fees and interest charges owed to SABIS Educational Systems for the 1997 fiscal year, and that the school deferred payment of $651,177 in charges owed to SABIS Educational Systems for the 1998 fiscal year. According to the 1998 audited financial statements, the school's revenues exceeded its expenditures for the 1996 and 1997 fiscal years, but its expenditures exceeded its revenues by $361,436 in the 1998 fiscal year.

In April 1999, when the Board of Education was considering the school's application to renew its charter for an additional five-year term, the Inspector General sent a letter to the Chairman of the Board of Education and the Commissioner of Education, alerting

them to financial concerns raised by the information in the school's audited financial statements. The DOE Commissioner responded to the Inspector General's concerns in a June 1999 letter. The Commissioner's letter acknowledged that the school had not been timely in paying accrued charges owed to SABIS Educational Systems. However, the letter expressed the opinion that, based on a review of the school's finances over its first three years of operation, the DOE's staff had identified a pattern of financial viability and stability.[73] According to the Commissioner's letter, the school had provided the DOE with a written statement that it expected to have paid all debt to SABIS Educational Systems by June 30, 2000. On June 29, 1999, the Board of Education voted to renew the school's charter for an additional five-year period.

Somerville Charter School

According to the school's audited financial statements, the school's current ratios for both the 1997 and 1998 fiscal years were below 1: its current ratio was .78 as of June 1997 and .84 as of June 1998. As discussed earlier in this report, the school deferred payment until the 1998 fiscal year of $670,115 in fees and other obligations owed to SABIS Educational Systems in the 1997 fiscal year. The school also deferred payment until the 1999 fiscal year of $724,232 in fees and other obligations owed to SABIS Educational Systems in the 1998 fiscal year. As of June 1998, the school owed $1,139,232 to SABIS Educational Systems; this amount included unpaid management fees as well as other financial obligations. The audited financial statements showed

[73] The Commissioner's letter attributed the school's low current ratio for the 1998 fiscal year to the classification of a school lease of buildings and land from SABIS Educational Systems as a capital lease, and stated that the school was considering the option of restructuring the lease as an operating lease. The letter also pointed to increases in the school's cash from operating activities as evidence of the school's economic viability. However, the school's audited financial statements also showed that the school's unpaid fees, loan balances, and other charges owed to SABIS Educational Systems increased substantially – by more than $400,000 – from the end of the 1997 fiscal year to the end of the 1998 fiscal year. These were among the trends prompting the Inspector General's April 1999 letter.

that the school's revenues exceeded its expenditures by $136,082 in the 1997 fiscal year and $363,896 in the 1998 fiscal year.[74]

Finding 11. Independent auditors of 17 charter schools reported deficient internal control systems that could adversely affect the efficiency and integrity of the schools' business operations.

An organization's system of internal controls is central to its capacity to fulfill its mission. The term "internal controls," sometimes referred to as "management controls," refers to the policies, procedures, and organizational arrangements that organizations use to plan, budget, manage and evaluate their operations.[75] Effective internal control systems are designed to promote results-based accountability by:

- increasing the organization's capacity to fulfill its mission and objectives;
- providing reasonable assurance that resources are being used in a manner that is consistent with the organization's mission;
- protecting the organization from waste, fraud, and mismanagement;
- promoting compliance with applicable laws and regulations; and
- producing and maintaining reliable, timely information for decision-making purposes.

Internal controls cannot assure that an organization will succeed in accomplishing these objectives; rather, they constitute a set of tools that promote efficient and cost-effective management while protecting the organization's integrity.

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[74] As noted in the previous Finding 2, the school owed SABIS Educational Systems surplus payments of $136,082 in the 1997 fiscal year and $343,896 in the 1998 fiscal year. The school's audited financial statements indicated that the $20,000 difference between the school's reported surplus and the surplus payment owed to SABIS Educational Systems in the 1998 fiscal year was comprised of temporarily restricted net assets for after-school programs in the 1998-1999 school year.

[75] The following discussion of internal controls is drawn from *Circular No. A-123*, "Management Accountability and Control," U.S. Office of Management and Budget, July 1995, and from *Government Auditing Standards, 1994 Revision*, U.S. General Accounting Office, June 1994.

The generally accepted government auditing standards that charter schools (and many other publicly funded organizations) must meet are published by the U.S. General Accounting Office (GAO).[76] These standards require the independent auditors preparing the annual audits to report on the school's financial statements as well as on internal control deficiencies that they consider to be "reportable conditions." GAO standards also call for independent auditors to report other deficiencies in internal controls to the audited entity, even if those deficiencies are not reportable conditions.

The GAO standards include the following examples of internal control deficiencies that may be reportable conditions:

- absence of appropriate segregation of duties;[77]
- absence of appropriate reviews and approvals of transactions;
- inadequate provisions for safeguarding assets;
- evidence of failure to safeguard assets from loss, damage, or misappropriation;
- significant deficiencies in the design or operation of internal controls that could result in violations of laws or regulations directly and materially affecting the financial statements; and
- failure to follow up and correct previously identified deficiencies in internal controls.

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[76] As of the publication of this report, the most recent standards were contained in *Government Auditing Standards, 1994 Revision*, U.S. General Accounting Office, June 1994, and subsequent amendments.

[77] The term "segregation of duties" refers to a fundamental and widely recognized internal control for both public and private organizations. The general principle underlying segregation of duties is that, in order to reduce the risks of loss or misuse of funds as well as the risks of failing to detect errors or abuses, no one individual should be responsible for all phases or aspects of a transaction. Instead, the key duties and responsibilities for authorizing, processing, recording, and reviewing official transactions should be separated among multiple individuals. Similarly, an individual who has custody of the organization's assets – such as cash or checks – should not have access to or responsibility for the accounting records for those assets.

Reports on internal control deficiencies are not generally included in the independent audits themselves. Rather, independent auditors provide these reports to the audited entities in a separate document typically referred to as a "management letter."

The Office requested copies of all management letters issued to the 24 schools within the study scope from July 1994 through January 1999. The Office obtained 35 management letters issued to 17 of the 24 schools in this review. Six of the 35 management letters pertained to the 1996 fiscal year, 12 management letters pertained to the 1997 fiscal year, and 17 management letters pertained to the 1998 fiscal year.

The 35 management letters identified a broad range of internal control deficiencies at the 17 schools, including the following:

- inadequate expenditure and cash disbursement practices;
- insufficient segregation of duties;
- failure to segregate the accounting systems and operating procedures of the school and the private foundation established for fundraising and financial assistance;
- lack of a detailed operating budget;
- lack of written accounting and procurement manuals;
- lack of procedures for identifying, accounting for, tracking, and disposing of fixed assets owned by the school;
- inadequate procedures for overseeing and complying with the requirements of state and federal grants; and
- lack of policies for record-keeping and records retention.

The management letters prepared by the schools' independent auditors highlighted specific policies, procedures, and organizational arrangements that, in the opinion of the independent auditors, could adversely affect the schools' capacity to record, process, summarize, and report financial data consistent with the information provided by the schools in the financial statements. In some cases, the deficient internal controls, if left uncorrected, could render the schools vulnerable to fraud, waste, and abuse.

Some charter schools have reportedly taken timely actions to strengthen their internal control systems in response to deficiencies cited by their independent auditors.

The Office's review of management letters issued by independent auditors in conjunction with their financial audits of charter schools for the 1996, 1997, and 1998 fiscal years indicated that some schools instituted measures to strengthen their operating procedures in response to their independent auditors' findings of deficient internal controls. The following examples illustrate the importance of these reports, or management letters, as an effective management tool to assist boards of trustees in protecting their schools from risks that could compromise the financial viability and integrity of their operations.

Benjamin Banneker Charter School

In a December 1997 management letter to the Board of Trustees, the school's independent auditor recommended that the school take action to remedy several significant internal control deficiencies. For example, the independent auditor cited the lack of a formal accounting manual and offered the following recommendation:

> A written accounting manual may be necessary to ensure that transactions are treated in a standardized manner, that regulations are being complied with, and that proper internal control exists within the organization. We recommend that operating guidelines for fiscal activities and compliance responsibilities be prepared including a description of each procedure, such as purchasing and receiving, invoice paying, maintenance of accounts receivable and accounts payable subsidiary records, and payroll procedures. We also recommend that the School include an organizational chart within this manual which communicates levels of responsibility and lines of authority.

The independent auditor's management letter also cited the school's lack of formal procedures for procuring goods and services, inadequate controls over expenditures and cash disbursements, and inadequate documentation and record-keeping practices.

The management letter noted that the school had reported having remedied these problems in the 1998 fiscal year. Although the management letter issued by the

school's independent auditor in November 1998 contained several new recommendations for strengthening the school's internal controls, the independent auditor did not reiterate the previous year's criticisms.

Boston Renaissance Charter School

In an October 1996 management letter, the school's independent auditor recommended that the Board of Trustees take steps to improve its oversight of The Edison Project, the management contractor providing educational and administrative services to the school. The report stated, in part:

> [T]he Board has delegated the day-to-day managerial function of the School to Edison. However, the Board retains ultimate responsibility to ensure that the terms of the School's Charter and the pertinent provisions of Massachusetts General Laws are adhered to. In order to adequately discharge this responsibility, it is imperative that the Board create a system within which it can monitor the effectiveness of Edison, both from educational and financial perspectives.

The independent auditor recommended that the school establish a business office, headed by a Chief Executive Officer. The independent auditor also recommended that the school develop a plan to address its operating deficit, improve its capacity to monitor grant compliance, develop an inventory tracking system, and establish procedures for ensuring that the operations and record-keeping functions of the school and its non-profit foundation were separated. In its written response, the school stated that it would implement all of the independent auditor's recommendations.

In an August 1997 management letter, the independent auditor congratulated the Board of Trustees on having hired a President to serve as liaison between the school and The Edison Project, and on having executed an amendment to its contract with The Edison Project clarifying The Edison Project's responsibilities. In a September 1998 management letter, the independent auditor also praised the school's accomplishments and cited a number of improvements effected by the school's creation of an Executive Office, including more active oversight of financial affairs, monitoring of The Edison

Project's contract and budget, reduction of the school's operating deficit, and improved grant compliance monitoring.

South Shore Charter School

The school's independent auditor issued a "schedule of reportable conditions" for the year ended June 30, 1996. This document cited two internal control deficiencies: insufficient segregation of responsibilities within the accounting department, and insufficient accounting and record-keeping personnel to perform their required responsibilities. The following year's schedule of reportable conditions for the year ended June 30, 1997 stated that the school had addressed most of the problems identified in the previous year's report, but that several areas required further action to reduce the risks of unauthorized or inappropriate transactions. The schedule of conditions for the year ended June 30, 1998 did not cite these internal control deficiencies.[78]

Some charter schools have reportedly failed to take timely actions to correct previously identified deficiencies in their internal control systems.

The Office's review of management letters for the 1996, 1997, and 1998 fiscal years disclosed that some schools appear not to have taken prompt action to strengthen their operating procedures in response to their independent auditors' management letters and reports on internal controls.[79] The schools' reasons for failing to implement the

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[78] In May 1999, the State Auditor issued a *Report on Certain Activities of the South Shore Charter School* for the period of July 1, 1995 through December 31, 1997. The *Report* revealed that the school had improperly administered and used retirement funds, that the school lacked documentation to support billings to the state; that some school expenses were undocumented, inadequately documented, or not properly approved; and that the school's internal controls were inadequate in several areas of its business operations.

[79] As noted earlier in this section, failure to follow up and correct previously identified deficiencies in internal controls is itself an internal control deficiency that may constitute a reportable condition.

measures recommended by their independent auditors reportedly included lack of resources.

Atlantis Charter School

In a January 1997 management letter, the school's independent auditor raised concerns regarding the school's internal controls. For example, the independent auditor reported that the school lacked a written accounting manual, formal procurement policies, a formal organizational chart delineating individual responsibilities and lines of authority, and procedures governing fixed assets; that the school required only one signature for check disbursements, regardless of the amount; and that the school maintained one accounting system for the school and the private non-profit corporation established to support the school. The independent auditor recommended that the school take steps to address these and other problems.

The following year, the school's independent auditor identified these same internal control problems, using identical language. The independent auditor's October 1997 management letter contained no indication that the school had made progress in addressing these problems.

The independent auditor's November 1998 management letter disclosed that the school still did not have a formal accounting manual[80] or formal procurement policies; the school's cash disbursements lacked sufficient controls; the school still had not adopted procedures governing fixed assets; and the school had continued to use the same accounting system for the school and its non-profit foundation.

Hilltown Cooperative Charter School

In a January 1997 management letter, the school's independent auditor raised concerns about the school's failure to establish separate governing boards and accounting systems for the school and its non-profit foundation, warning:

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[80] According to the management letter, the school was in the process of drafting an accounting manual.

> It is critical that the distinction between the charter school and its fundraising entity be maintained so that liability issues and other legal issues do not affect the status of the charter school as a public school.

The independent auditor also reported that the school lacked an accounting procedures manual and emphasized the importance of good accounting procedures to the school's efficient operations:

> The school does not have an accounting procedures manual. There may be an assumption that because the school's accounting system is relatively simple there is no need for a manual. However, written procedures, instructions, and assignment of duties will prevent or reduce misunderstandings, errors, inefficient or wasted effort, duplicated or omitted procedures, and other situations that can result in inaccurate or untimely accounting records. . . . It will take some time and effort for management to develop a manual; however, I believe this time will be more than offset by time saved later in training and supervising personnel. . . . .

The independent auditor's January 1998 management letter contained identical descriptions of the internal control problems cited above and contained no indication that the school had taken steps to implement the 1997 recommendations. The independent auditor's December 1998 management letter noted that the school had developed written accounting procedures for some activities, but reiterated the recommendation from the previous two years' reports that such procedures be assembled into an accounting manual. This report also contained the warning from the previous two years' reports regarding the school's relationship with its non-profit foundation.

North Star Academy Charter School

In a March 1998 management letter for 1997 fiscal year, the school's independent auditor noted that the school had not complied with the DOE's submission deadline for

the school's audited financial statements.[81] The independent auditor also identified a series of reportable conditions, including the following: missing original invoices for some expenditures; the lack of a formal fiscal year budget, approved by the Board of Trustees, conforming with the school's accounting system; the lack of bonding or insurance[82] covering employees with access to cash, bank accounts, or other liquid assets;[83] and inadequate maintenance and monitoring of the school's inventory of school supplies.

In a June 1999 management letter for the 1998 fiscal year, the school's independent auditor identified 11 reportable conditions, four of which the auditor determined to be material weaknesses. A material weakness is a reportable condition that, in the independent auditor's opinion, poses risks that material misstatements in financial statements could occur without timely detection by employees in the normal course of performing their assigned functions. The material weaknesses reported by the independent auditor were as follows:

1. Failure to monitor compliance with the Commonwealth's audit requirements and standards (see below);
2. Missing and inaccurate bank account reconciliations, and lack of evidence of review by a responsible official independent of the preparer;
3. Inappropriate fixed asset capitalization policy; and
4. Lack of a written conflict of interest policy.

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[81] DOE regulations require charter schools to file audited financial statements with the DOE and the State Auditor by January 1 of the year following the audit year. The school did not file its 1997 audited financial statements until the spring of 1998; it did not file its 1998 audited financial statements until the summer of 1999.

[82] For example, fidelity bonds are a form of insurance that protects an employer from the potentially catastrophic financial consequences of employee fraud or dishonesty.

[83] In response, the school stated that it had obtained an insurance policy for employee dishonesty covering all employees with signature authority or with access to cash or checks.

The other reportable conditions included the lack of a formal budget conforming with the fiscal year and the school's accounting system, insufficient grant record-keeping procedures, and inadequate sign-off of payroll registers.

The management letter's explanation of the first material weakness cited above focused on the school's lack of preparation for the 1998 audit. The letter stated:

> The audit was scheduled twice during the period from the end of the fiscal year, August and November/December. During those periods, we noted that North Star Academy personnel were unprepared for the audit, did not effectively communicate with one another and did not devote substantive time to coordination within the Organization to facilitate the audit and accommodate independent audit personnel. Further, the accounting records contained obvious errors that evidenced lax bookkeeping, lack of controls and failure to follow internal procedures that were represented as being implemented and operating (including, but not limited to, prior year audit adjusting entries not recorded and an unrecorded motor vehicle loan). Follow-up was, in many cases, inadequate or inappropriate.[84]

SABIS International Charter School

The financial statements for the 1996 fiscal year prepared by the school's independent auditor cited the insufficient segregation of duties within the payroll functions at the school as a reportable condition. The independent auditor noted:

> The lack of segregation of duties allows the individual responsible for payroll to generate checks for nonexistent employees or make unauthorized changes in rates to current employees which would not be detected.

In an August 1996 management letter to the school issued in conjunction with the financial statements, the school's independent auditor identified a series of internal control weaknesses in addition to the payroll issue. These problems included the following:

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[84] The management letter included a response from the school stating that its move to new quarters in August 1998 had inhibited its ability to complete the audit, that it had been unaware that the auditors would be unavailable from January through April, and that the school's Financial Director had tendered his resignation effective June 30, 1999.

- Insufficient separation of duties for processing cash receipts, accounts payable, and payroll;
- Failure to reconcile the Board's cash account;
- Insufficient review of the school's operating bank statement by the school's Director;
- Lack of signatures providing evidence of financial reviews and approvals by the school's Director;
- Lack of an accounting procedures manual; and
- Failure to train more than one individual to perform the school's accounting function.

The school had contracted with SABIS Educational Systems for substantially all educational and administrative services since August 1995. This arrangement – under which the school's finances and business operations were being managed by a private contractor rather than school employees – served to heighten the risks posed by the lack of segregation of duties and other internal control weaknesses identified by the school's independent auditor.

The school's independent auditor did not issue a management letter in 1997; instead, the independent auditor provided its internal control findings to the school via an oral presentation.[85] The school provided the Office with copies of the independent auditor's slides accompanying the oral presentation. The slide entitled "Management Comments" contained the following list of issues, all of which appear to mirror the internal control problems cited the previous year:

- Cash
  - Reconcile Board Cash Account
  - Review and Approval

[85] It should be noted that generally accepted government auditing standards (GAGAS) require an independent auditor to provide a written report to the audited entity on reportable conditions in internal controls. Under GAGAS, a written report is the preferable mode of communicating deficiencies in internal controls that are not reportable conditions. According to the DOE's Technical Advisory 98-1 to charter schools, charter schools are required to follow GAGAS as conditions of their charters.

- Accounting Manual
- Cross-Training
- Reconcile [SABIS Educational Systems] Activity

The school contracted with a different independent auditor for its 1998 audit. In a December 1998 management letter to the Board of Trustees, the independent auditor cited the same reportable condition cited by the former independent auditor in the 1996 management letter: insufficient segregation of accounting and administrative duties. The 1998 management letter stated:

> The size of the School's accounting and administrative staff precludes certain internal controls that would be preferred if the office staff were large enough to provide optimum segregation of duties. However, there needs to be better segregation of duties in the following areas:
>
> - Responsibility for the general ledger is not separate from the cash receipts and cash disbursement functions.
> - One person is responsible for processing invoices and the general ledger function.
> - The checks are returned to the preparer for mailing after being signed.
>
> These duties should be segregated in order to strengthen internal controls.

The 1998 management letter identified other deficiencies in the school's administrative procedures, including the following:

- The capital lease with SABIS Educational Systems and depreciation expense were not accurately recorded on the interim financial statements.
- The school did not maintain detailed fixed asset records, nor were fixed assets tagged for identification.
- The school lacked a complete accounting policies and procedures manual.

The 1998 management letter also called attention to the school's failure to execute detailed written agreements governing its financial transactions with SABIS Educational Systems:

> MANAGEMENT AGREEMENT
>
> The management agreement between SABIS Educational Systems and the School does not define the management and license fees to be paid to SABIS Educational Systems, Inc. An amendment specifying these fees should be added to prevent future misunderstandings.
>
> LOAN AGREEMENT
>
> The School frequently borrows and repays funds to SABIS Educational Systems, Inc., the management company. We recommend the development of a written agreement between the School and SABIS Educational Systems, Inc. to formally define the terms and conditions of the loan in order to avoid misunderstandings.

Somerville Charter School

In a December 1997 management letter, the school's independent auditor issued a management letter citing the following reportable condition:

> SEGREGATION OF DUTIES
>
> During our audit we noted several areas with a segregation of duties problem. One person has each of the following duties that should be segregated:
>
> 1. Responsibility for the general ledger is not separate from the cash receipts and cash disbursement functions.
> 2. The person who enters the information for the payroll service is the same person that distributes the checks.
> 3. One person has complete control over the collections, deposits, and general ledger of the extended day account.
> 4. One person is responsible for purchasing and receiving.
> 5. One person is responsible for processing invoices and the general ledger function.

These duties should be segregated in order to strengthen internal controls.[86]

The independent auditor also reported a series of internal control deficiencies, including the following:

- Lack of fidelity bond coverage for accounting personnel, which could expose the school to financial losses;
- Failure to reconcile the payroll reports from the payroll service to the amounts actually paid from the payroll account;
- Lack of a detailed school budget;
- Lack of detailed fixed asset records and a fixed asset inventory system;[87]
- Lack of an accounting policies and procedures manual;
- Lack of a vacation or sick leave policy for administrative personnel; and
- Lack of a written loan agreement between the school and SABIS reflecting the school's frequent borrowing and repayment of funds to SABIS.

The school had contracted with SABIS Educational Systems for substantially all educational and administrative services since October 1996.

In December 1998, the independent auditor issued a management letter citing the same reportable condition that had been cited one year earlier: lack of segregation of duties. The management letter also noted additional internal control deficiencies within the school, including the following problems that had been reported in the prior year's management letter:

- Failure to reconcile the payroll reports from the payroll service to the amounts actually paid from the payroll account,
- Lack of an accounting policies and procedures manual, and

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[86] The management letter noted that the school had reported having corrected the segregation of duties problems in three of the above-listed areas by the end of 1997.

[87] The management letter noted that the school had reported having developed a fixed asset capitalization policy by the end of 1997.

- Lack of a written loan agreement between the school and SABIS reflecting the school's frequent borrowing and repayment of funds to SABIS.

Finding 12. DOE oversight of charter schools' financial condition and business practices has been inadequate.

Although the charter school law and regulations require the DOE to provide sufficient oversight to ensure that charter schools are financially solvent and stable, the DOE has not developed standards or procedures to facilitate reliable, systematic monitoring and evaluation of each school's financial condition. Moreover, although the DOE has informed all charter schools that they are required as a condition of their charters to follow sound business practices, including the establishment of a documented system of internal controls, the DOE has no reliable method of verifying that schools have complied with this charter condition. According to the DOE's Acting Associate Commissioner, the DOE recognizes the need to develop standards for evaluating charter schools' financial condition and business operations.

Charter schools are not currently required to provide the DOE with management letters issued by their independent auditors reporting on internal control deficiencies.

While the charter school law requires charter schools to submit their audited financial statements to the DOE each year, it does not specifically require the schools to provide the DOE with management letters or other reports on internal controls issued by their independent auditors in conjunction with the annual audits.[88] In recognition of this omission, the State Auditor recommended in a 1998 report that the DOE require charter schools to submit copies of management letters with their audits to the DOE each year.[89] Requiring schools to provide copies of all management letters to the DOE, as recommended by the State Auditor, would ensure that the DOE is fully apprised of

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[88] M.G.L. c. 71, §89(hh).

[89] Auditor of the Commonwealth, *State Auditor's Report on Establishing Standardized Accounting and Reporting Methods for Massachusetts Charter Schools Pursuant to Chapter 46 of the Acts of 1997* (1998), 3-4.

internal control deficiencies identified by the school's independent auditors as well as any actions taken by the schools in response to the independent auditors' findings.

The annual reports issued by some charter schools have not consistently complied with financial reporting requirements.

Under the charter school law and the DOE's charter school regulations, each charter school is required to submit an annual report to the Board of Education, to each parent or guardian of its enrolled students, and to each parent or guardian contemplating enrollment in that charter school. The report, which covers the preceding school year, is required to include the following financial information:

1. A financial statement setting forth by appropriate categories the revenues and expenditures for the year just ended;
2. A balance sheet setting forth the charter school's assets, liabilities, and fund balances or equities; and
3. Projections of income and expenses for the upcoming school year.[90]

The Office's review of the annual reports on file with the DOE showed that 10 of the 24 schools in this review submitted annual reports omitting at least one of the three items listed above from their 1998 annual reports. (Two schools omitted two of the three items, and one school omitted all three items.) In 1997, four of the 21 schools that had operated during the previous school year submitted annual reports omitting at least one of the three items. In 1996, six of the 14 schools that had operated during the previous school year submitted annual reports omitting at least one of the three items. The DOE did not require schools submitting incomplete reports to furnish the missing financial information.

[90] 603 CMR 1.08.

In a recent interview, the DOE's Acting Associate Commissioner stated that the DOE recognized the need to strengthen its financial oversight of charter schools.[91] With respect to the annual reports filed by charter schools, he stated that the DOE planned to establish annual report review protocols to identify missing information and to monitor report quality.

[91] In response to a draft version of this report, the DOE Commissioner stated that the DOE's revised process for evaluating a new charter school's preparedness to open incorporates a review of each school's internal financial controls as well as its policies and procedures for fiscal oversight and management. He stated that the DOE intends to add to this work by providing further guidance to all charter schools, new and old, regarding sound fiscal oversight and control.

VI. Procurement Procedures

Background

Massachusetts public elementary and secondary schools are required to follow the competitive procedures of M.G.L. c. 30B in procuring supplies, services, and real property. M.G.L. c. 30B, which applies to approximately 1,500 local governmental jurisdictions in Massachusetts, requires the solicitation of informal price quotations for supply and service contracts from $1,000 to $9,999 and formal, advertised competition using sealed bids or proposals for supply and service contracts of $10,000 or more. M.G.L. c. 30B also sets forth competitive procedures for disposing of surplus supplies and acquiring or disposing of real property. (Section VII of this report discusses charter school facility leasing.)

The charter school law contains no competitive requirements for charter school purchases. However, Chapter 46 of the Acts of 1997, which amended the charter school law, contained a provision requiring charter school administrators serving as procurement officers to participate in and obtain certification in the Massachusetts Certified Public Purchasing Official (MCPPO) program[92] conducted by the Office of the

[92] The Office offers the following three-day seminars in the MCPPO program: "Public Contracting Overview," which is a prerequisite for other courses and includes segments on purchasing principles, ethics, and Massachusetts purchasing laws; "Supplies and Services Procurement," which trains participants to use invitations for bids and requests for proposals to make best value procurements of supplies and services under M.G.L. c. 30B; and "Design and Construction Contracting," which provides training in the procurement laws governing public construction in Massachusetts and in effective design and construction contract administration. As of November 1999, 16 of the 24 schools in this review had sent or made arrangements to send representatives to one or more MCPPO seminars.

Inspector General.[93] In addition, Horace Mann charter schools are subject to the provisions of M.G.L. c. 30B.[94]

In August 1995, the Executive Office of Education (EOE) issued Charter School Legal Memorandum 95-13 advising Massachusetts charter schools that they, like other public schools, were required to comply with the provisions of certain state laws, including M.G.L. c. 30B. In June 1996, the EOE issued Charter School Legal Memorandum 96-3, which listed M.G.L. c. 30B among the laws applicable to charter schools.[95] However, in July 1998, the DOE issued Charter School Technical Advisory 98-1 notifying charter schools that the DOE had determined that M.G.L. c. 30B did not apply to charter schools:

> Commonwealth charter schools, which operate under a charter granted by the Board of Education, are, as a matter of law, instrumentalities of the state. They are established and operated independent of any municipal or regional school committee. As a result, these schools are not subject to the procurement requirements of the Uniform Procurement Act (G.L. c. 30B), which governs "governmental bodies" of cities, towns, districts, and counties.

The DOE advisory also stated that charter schools were required, as a condition of their charters, to follow sound business practices. The advisory provided the following explanation of the types of systems and procedures that would constitute sound business practices:

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[93] Chapter 46 of the Acts of 1997, §10.

[94] The DOE's Charter Schools Technical Advisory 98-2, issued in August 1998, stated: "Because Horace Mann school employees are, for some purposes, employees of municipal entities, and because the schools are funded directly by municipalities, they are by definition subject to the procurement requirements of G.L. c. 30B, the Uniform Procurement Act."

[95] The two EOE memoranda also informed charter schools of their obligation to comply with the state's open meeting law, M.G.L. c. 30A, §11A½; the construction bidding law for public building projects exceeding $25,000, M.G.L. c. 149; and the public records law, M.G.L. c. 66. The memoranda contained no references to M.G.L. c. 7, the designer selection law, and M.G.L. c. 30, §39M, the construction bidding law for public building projects up to $25,000 and for public works projects.

Within the context of procurements by a Commonwealth charter school, sound business practice means those activities that a prudent purchaser would consider to be reasonable under the circumstances. In this sense, sound business practices and reasonable procurement policies would, at a minimum, include documentation of the following:

A system of internal controls, including generally accepted accounting principles that ensure that funds are appropriately received, expended, and accounted for.

A procurement process that provides for the greatest amount of competition, gives potential bidders sufficient information upon which to base their bid or quote, and employs a process of evaluating bidders' responses which enables the charter school to determine the best value proposal.

Policies and procedures that ensure the procurement process is consistent with and based upon the internal control system of the organization, and which provide sufficient documentation for audit purposes.

Depending on the nature and monetary value of the procurement, sound business practice and reasonable procurement policies may be comprised of simply obtaining three or more written quotes and selecting the lowest quote that offers the required goods and services. This practice may be most applicable when the procurement is intended to be relatively small in value (under $5,000). **For larger or more complex procurements, sound business practice and reasonable procurement policies may require a formal request for response, a formal response, and an evaluation process, which both defines and produces the best value result of the procurement.** [Emphasis added.]

The DOE advisory recommended that charter schools consult the procurement manuals issued by the state Operational Services Division and the Massachusetts Office of the Inspector General for guidance on establishing or evaluating their procurement procedures.

In June 1998, one month before the DOE issued this advisory, the Office requested that the 24 charter schools within the scope of this review provide the Office with all rules, regulations, policies, and procedures pertaining to their procurements of supplies, services, and equipment. Four of the 24 schools submitted written procurement procedures, and 11 others described their procedures in letters to the Office. In

January 1999, six months after the DOE advisory was issued, the Office again requested that the 24 schools provide the Office with all current written rules, regulations, policies, and procedures pertaining to their procurements of supplies, services, and equipment. The purpose of this second request was to determine whether schools had developed written procurement procedures designed to foster competition for supplies and services in accordance with the July 1998 DOE Advisory. This time, 11 schools submitted written procedures and eight schools described their procedures in letters to the Office.

The findings contained in this section of the report are based on the information provided by the 24 schools in early 1999. The Office did not audit specific school procurements to determine the procurement methods used by schools that lacked written procurement procedures or to determine whether the schools that had adopted written procurement procedures were in fact conducting procurements in accordance with those procedures. Rather, the Office's review of each school's procedures addressed two questions:

- Did the school adopt written procurement procedures, as required by the 1998 DOE advisory?
- If so, did the school's written procurement procedures require formal competition and best value contracting, as required by the DOE advisory?

Table 4 on the following two pages summarizes the procurement procedures provided by the 24 schools as of early 1999.

Table 4. Summary of School Procurement Procedures as of January 1999

School	No Written Procedures	Written Procedures			Comments
		Competition required			
		Advertising required	Advertising not required	Competition not required	
Academy of the Pacific Rim			X		Procedures did not cover procurement of services.
Atlantis	X				
Benjamin Banneker			X		Procedures did not cover procurements exceeding $10,000.
Benjamin Franklin Classical			X		
Boston Renaissance	X				
Boston University	X				
Cape Cod Lighthouse		X			Procedures required compliance with M.G.L. c. 30B.
Chelmsford Public			X		Procedures did not cover procurements exceeding $15,000.
City on a Hill			X		Procedures did not cover procurements exceeding $15,000.
Community Day	X				
Francis W. Parker	X				
Hilltown Cooperative	X				

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Table 4. Summary of School Procurement Procedures as of January 1999 (continued)

School	No Written Procedures	Written Procedures			Comments
		Competition required			
		Advertising required	Advertising not required	Competition not required	
Lawrence Family Development	X				
Lowell Middlesex Academy		X			Procedures required compliance with state agency procurement rules.
Lynn Community			X		Procedures provided for advertising at the discretion of the school principal.
Marblehead Community	X				
Martha's Vineyard	X				
Neighborhood House			X		
North Star Academy	X				
Pioneer Valley Performing Arts				X	
SABIS International			X		
Seven Hills	X				
Somerville	X				
South Shore	X				

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Procurement Procedures and Best Value Contracting

Written procurement procedures formalize an organization's purchasing practices. They also help ensure that the organization's purchasing rules are uniformly applied and consistent with the organization's mission. Conversely, the absence of written procurement procedures increases the likelihood of procurement waste and inefficiency while reducing accountability. For these reasons, written procurement procedures constitute sound business practices.

Best value contracting means obtaining the best value for the public dollar, taking into consideration quality, performance, and price. Competition is a key element of best value contracting. Research has consistently demonstrated that without the discipline of the competitive marketplace, contracts for supplies and services with the private sector are neither efficient nor cost-effective.[96] In *The Privatization Decision: Public Ends, Private Means*, John Donahue noted:

> [H]alf of a market system – profit drive without meaningful specifications or competitive discipline – can be worse than none.[97]

Similarly, John Goodman and Gary Loveman, writing in the *Harvard Business Review*, warned that:

> [A] lack of competition for government contracts actually leads to higher costs and creates perceptions of corruption.[98]

In addition to promoting best value contracting, a public entity's procurements should ensure accountability through fair, open, systematic selection procedures. For larger

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[96] See, for example, John D. Donahue, *The Privatization Decision: Public Ends, Private Means* (HarperCollins, 1989), 78; Donald F. Kettl, *Sharing Power: Public Governance and Private Markets* (Brookings Institution, 1993); and Jonas Prager, "Contracting Out Government Services: Lessons from the Private Sector," *Public Administration Review*, (March/April 1994).

[97] (HarperCollins, 1989), 78.

[98] "Does Privatization Serve the Public Interest?," *Harvard Business Review* (November-December 1991), 34.

procurements, accountability requires a formal advertising process in addition to detailed specifications, explicit evaluation criteria, and documentation of the selection process.

As the following findings show, many charter schools had not developed written procurement procedures by January 1999. Of those that had developed written procurement procedures, most did not require advertised competition for any purchases, although some schools indicated in letters to the Office that they have attempted to seek informal competition for some purchases.

Finding 13. More than half of the 24 charter schools lacked written procurement procedures.

As of January 1999, six months after the DOE issued Charter School Technical Advisory 98-1, the following 13 charter schools still lacked written procedures governing their purchases of supplies, services, and equipment.

Atlantis
Boston Renaissance
Boston University Residential
Community Day
Francis W. Parker
Hilltown Cooperative
Lawrence Family Development
Marblehead Community
Martha's Vineyard
North Star Academy
Seven Hills
Somerville
South Shore

In response to the Office's request, some schools that lacked written procurement procedures advised the Office that they use competitive procurement methods. The schools' responses are excerpted below.

Atlantis Charter School

In a February 1999 letter to the Office, the school's Business and Technology Manager stated:

> Atlantis Charter School does not have a written, formal procurement policy to present to the Office of the Inspector General. We do our best to solicit three bids from vendors prior to issuing a purchase order for the acquisition. We utilize an internal control procedure whereby, to the

maximum extent possible, all school purchases are covered by purchase orders.[99]

Boston Renaissance Charter School

In a January 1999 letter to the Office, the President of the school stated:

> The Boston Renaissance Charter School has no documents that contain "rules, regulations, policies and procedures pertaining to the procurement of supplies, services, and equipment." Please be advised, however, that supplies, services and equipment procurement have been and continue to be guided by MGL Chapter 30B, utilizing sound business practices.

Boston University Residential Charter School

In an August 1998 letter to the Office, the Head of School stated:

> BURCS seeks bids on all supplies, services, and equipment with a value in excess of $1,000. The only exception to this rule is the purchase of proprietary supplies, services and equipment such as fire alarm systems where an existing vendor has exclusive access to needed parts, etc.

Community Day Charter School

In a February 1999 letter to the Office, the school's Chief Financial Officer stated:

> Our procedures for procuring supplies, services and equipment are based on sound business practices. This ranges from obtaining price quotes to requesting written bids, depending on the item and annual dollar value. We have a copy of the procurement manual issued by the Office of the Inspector General in our offices, and refer to it during our bidding processes.

Francis W. Parker Charter Essential School

In a July 1998 letter to the Office, the school's Business Manager stated:

> The school has no formal written policies and procedures pertaining to the procurement of supplies, services, and equipment. Following is a brief description of our current practices in this area: The school generally

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[99] The school was advised by its independent auditor to adopt a written procurement policy three times between January 1997 and November 1998.

requires the use of purchase orders for the purchase of goods, and approval by the appropriate departmental manager with budgetary authority for any goods or services acquired prior to payment being made. Where fiscally prudent (generally larger purchases) quotes are requested, although not formally required by policy. Smaller out-of pocket expenditures are permitted and reimbursed to staff or faculty if the same approval is obtained and receipts are provided, but a purchase order is not required in these instances. Payment for payroll is made in accordance with documented terms of employment; any exceptions to stated annual salaries require written authorization. This spring the business manager attended, and successfully completed, the Massachusetts public purchasing certification program conducted by your office. While not required to comply with these laws by statute, it is the intention of the business manger to consider these requirements when a formal policy is drafted for the approval of the Board of Trustees.[100]

Hilltown Cooperative Charter School

In an undated and unsigned letter received by the Office in July 1998, the school stated:

> Although the HCCS is not subject to the Uniform Procurement Act (30B), our practices reflect our commitment to the underlying spirit of this law. We seek to obtain the lowest price for all supplies, services and equipment, using a variety of techniques, including the following:
>
> -Membership in the Hampshire County Purchasing Service. This service conducts bids and procurement for its members according to the dictates of state mandate. HCCS purchases health insurance, office and school supplies through the service.
>
> -Written solicitation of bids for maintenance and other services.
>
> -Purchase of supplies and equipment from discount vendors.

Lawrence Family Development Charter School

In a July 1998 letter to the Office, the school's Comptroller stated:

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[100] The school was advised by its independent auditor in December 1997 to adopt a written procurement policy requiring competition for major purchases. In November 1998, the school's independent auditor reported that the school's established procurement policy, which required the solicitation of three quotes for purchases of $1,000 or more, had not been fully implemented.

> [Our business manager] has just completed the General Certification Seminar. Our business and accounting practices are also reviewed annually by our auditors.

Marblehead Community Charter Public School

In an undated letter received by the Office in July 1998, the school's Business Manager stated:

> General purchases are made from a variety of catalogues, suppliers and retailers. Members of the staff make requests for materials to the Head of School and/or Business Manager. Once approved as an appropriate expense, the Business Manager is responsible for finding the requested material (or equal) at the lowest possible cost. A Purchase Order is generated for review and approval by the Head of School and is then forwarded to the vendor. All Purchase Orders are kept on file in the Business Manager's office. When the shipment arrives, it is checked for completeness and distributed. Invoices are checked against the matching Purchase Order and entered into the school's electronic accounting system. All receipts and invoices are kept on file in the Business Manager's office.

Martha's Vineyard Public Charter School

In a July 1998 letter to the Office, the school's Business Manager stated:

> We buy supplies from state approved contracts when we can (copiers, toner etc.). For others, we use discount suppliers which guarantee the lowest prices, such as Quill and Staples. For services such as electrical repair and plumbing we use parents of students, whenever possible, who give us reduced prices. Living on an island, we have a limited base to choose from for services and when we find someone who does quality work we continue to use them. If there are multiple vendors, we always solicit bids.

North Star Academy Charter School

In a February 1999 letter to the Office, the school's Financial Director of the school stated:

> We follow the local school district practices for procurement of supplies, services, and equipment.

The school also forwarded a manual entitled "North Star Academy Charter School Cash Control Procedures Manual." However, the manual contained no specific procedures for procuring supplies, services, and equipment.

Somerville Charter School

In a February 1999 letter to the Office, the Corporate Accounting Manager for SABIS Educational Systems stated:

> In 1998 the Somerville Charter School answered your previous Document Request by providing the following: Copies of all current written rules, regulations, policies and procedures pertaining to the procurement of supplies, services and equipment. The Somerville Charter School has made no changes to its policies since this time.

However, the materials provided by the school in response to the Office's first request contained no specific procedures for procuring supplies, services, and equipment.

Seven Hills Charter School

In a February 1999 letter to the Office, an attorney representing The Edison Project stated:

> The Seven Hills Charter School has no "rules, regulations, policies and procedures pertaining to the procurement of supplies, services and equipment." Pursuant to the Management Agreement, Edison is responsible for the procurement of supplies, equipment and services. Under the contract, Edison may procure supplies on a local or on a national basis. Edison is currently managing approximately 50 schools nationwide, and is able to achieve economies of scale based upon national purchase or lease agreements. Edison employs a Business Service Manager at the school. Edison's Business Service Managers undergo extensive training, and are guided by policies set forth in an extensive "Business Service Managers Training Manual."

Although the school provided a copy of Edison's "Business Service Managers Training Manual" to the Office, the manual contained no specific procedures for procuring supplies, services, and equipment.

Finding 14. The written procurement procedures adopted by nine charter schools did not require advertised competition for purchases of supplies, services, and equipment.

Eleven schools submitted written procurement procedures in response to the Office's January 1999 request:

Academy of the Pacific Rim
Benjamin Banneker
Benjamin Franklin Classical
Cape Cod Lighthouse
Chelmsford Public
City on a Hill
Lowell Middlesex Academy
Lynn Community
Neighborhood House
Pioneer Valley Performing Arts
SABIS International

Two of the 11 schools – Cape Cod Lighthouse Charter School and Lowell Middlesex Academy Charter School – had adopted written procurement procedures that required advertising, set thresholds for formal competition, and defined evaluation criteria for evaluating competing vendors and making a final selection. However, the procurement procedures adopted by the other nine schools did not require advertising for any school purchases. Most also lacked clear rules for evaluating offers and identifying the best value offer. In several cases, the schools had adopted clear, competitive procurement procedures for smaller purchases but not for larger purchases. The procurement procedures of these nine schools that did not require advertising are discussed below.

Academy of the Pacific Rim Charter School

The school's procurement procedures, excerpted below, required unadvertised competition for "larger orders" of supplies and equipment; they did not cover service contracts. The procedures did not define "larger orders," nor did they contain rules for evaluating offers and selecting the best value offer.

> **Purchasing Procedures**
>
> All Academy of the Pacific Rim Faculty and Staff should follow the following procedures for the purpose of ordering supplies and equipment.
>
> 1. For general school supplies under $500. Send request to Administrative Assistant for processing[.]

2. Administrative Assistant will process orders on a weekly basis using the vendor with the best pricing for the items.

3. Purchase order numbers are obtained through the Business Manager.

4. The Business Manager orders larger orders of equipment and supplies after obtaining three quotes from reputable sources.

Benjamin Banneker Charter School

The school's procurement procedures required unadvertised competition for purchases over $1,000, but did not contain rules for evaluating offers and selecting the best value offer. Although they stated that purchases over $10,000 were subject to different procedures, the school did not provide the Office with written procedures applicable to purchases over $10,000. The procedures stated:

> Purchases over $1000 must have bids from at least 3 vendors.
>
> Purchases over $10,000 & purchases of real property will be covered in another procedure.

Benjamin Franklin Classical Charter School

While the school's procurement procedures set a clear dollar threshold for competition, the procedures did not require advertising, nor did they contain rules for evaluating offers and selecting the best value offer:

> 5.1.3. All expenditures for a single item and or vendor of over $2,000 must be sent out for bid of at least two other competitive vendors and retained on file.

The procedures also required that all of the school's existing contracts be competitively reprocured:

> 5.1.2. All contracts, leases (excluding real estate leased), policies, legal expenses, services under contractual agreements must be re-negotiated and sent out for bid of at least two other competitive vendors and approved by the Board of Trustees.

Chelmsford Public Charter School

Although the school's written procurement procedures governing purchases up to $15,000 were clear, detailed, and competitive, the procedures did not cover purchases exceeding $15,000. For these larger purchases, the school's procedures instructed school personnel to notify the school's management contractor, Beacon Education Management, of their purchase requirements:

> 3. When the value is estimated to be higher than $15,000:
>
> 3.1 The quantity sought should be determined.
>
> 3.2 The quality sought should be described.
>
> 3.3 A written statement of quantity, qualify, and delivery time.
>
> 3.4 E-mail this to your Beacon account representative.

The procedures did not specify the procurement methods to be used by Beacon Education Management for purchases exceeding $15,000, nor did they require Beacon Education Management to use competitive procurement methods.[101]

City on a Hill Charter School

Like Chelmsford Public Charter School, City on a Hill Charter School's written procurement procedures governing purchases up to $15,000 were clear, detailed, and competitive but did not cover purchases exceeding $15,000. For these larger purchases, the school's procedures instructed school personnel to notify the school's management contractor, Beacon Education Management, of their purchase requirements:

> 3. When the value is estimated to be higher than $15,000:
>
> 3.1 The quantity sought should be determined.

[101] The school's June 1998 contract with Beacon Education Management required the contractor to solicit bids for food services on behalf of the school; however, the contract contained no other provisions regarding Beacon Education Management's procurement responsibilities.

3.2 The quality sought should be described.

3.3 A written statement of quantity, qualify, and delivery time.

3.4 E-mail this to your Beacon account representative.

The procedures did not specify the procurement methods to be used by Beacon Education Management for purchases exceeding $15,000, nor did they require Beacon Education Management to use competitive procurement methods.[102]

Lynn Community Charter School

The school's procurement procedures required competition and contained clear rules for evaluating offers and selecting the best value offer. However, the procedures stated that advertising was optional:

> **At the discretion of the Principal, the request for proposal will be advertised in the local Lynn newspaper at least two weeks before the bids or proposals are due.** The advertisement will also be posted in a conspicuous location near the School administrative offices and will be sent to product and service providers that are known to the school. In all cases, the school will actively work to get at least three competing bids for all products and services.
>
> The buyer will evaluate proposals based on price and on situational factors that affect the advantageousness of the proposal. Awards will be made to the most advantageous bidder based on all factors. [Emphasis added.]

Neighborhood House Charter School

The school's procurement procedures required competition and contained clear rules for evaluating offers and selecting the best value offer. However, the procedures did not require advertising:

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[102] The school's contract with Beacon Education Management, which took effect April 1, 1998, required the contractor to procure school supplies, custodial services, food service, and other service contracts in accordance with the requirements of M.G.L. c. 30B for fiscal years 2000 and 2001.

> Staff shall solicit written price quotes from three or more vendors. The solicitation of price quotes or a Request for Proposals shall contain a description of the items to be purchased or the services to be provided. Staff shall take into consideration both price and non price factors (quality of service, experience, etc.) in making a procurement decision. Unless appropriate justification is made otherwise, the vendor with the lowest price shall be selected. A copy of the price quotes or proposals and the justification for the selected vendor shall be maintained for three years. The procurement of goods and services in this price range must be approved by the Headmaster or Chief Financial Officer.

Pioneer Valley Performing Arts Charter High School

The school's procurement procedures, which were outlined in an August 1998 memorandum from the school's business office to all staff, contained information on requisitioning items from the school's business office,[103] but provided no indication that competition was required for any school procurements. As the following excerpt shows, the procedures encouraged school staff to suggest the vendor from which items should be ordered, a practice that could discourage competition:

> 2>Please complete the [requisition] form in its entirety with the information requested. There can never be too much information. **Do not forget to include suggested vendor**, item order number and a full description where possible. Questions arising from a lack of information will only serve to delay your request.
>
> 3>If no substitutes can be accepted, please note that on your form. Otherwise if alternatives are available they may be ordered (such as with office supplies). [Emphasis added.]

SABIS International Charter School

The school's procurement procedures consisted of one paragraph, quoted in its entirety below. While the procedures required an informal bidding process for larger purchases, they did not require advertising, nor did they specify a process for evaluating and selecting competing offers from vendors or the dollar threshold for purchases requiring informal bidding.

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[103] The procedures also included instructions for purchase order processing, receipt of ordered items, and record-keeping.

Procurement of supplies and services should follow sound business practices. When preparing to order supplies or services obtain from several sources the current price of the item(s). This information can be obtain[ed] through catalogs, Internet or contact with sales personnel. Order the needed items from the lowest, responsive and responsible supplier(s). For larger purchases, such as furniture, contact several supplie[r]s and provide them with detailed specifications allowing them a reasonable amount of time to put together a bid.

VII. Facility Leasing

Background

The charter school law states:

> A charter school may be located in part of an existing public building, in space provided on a private work site, in a public building, or any other suitable location. A charter school may own, lease, or rent its space.[104]

The task of locating and paying for an adequate school facility poses a daunting challenge to prospective founders of charter schools as well as to newly chartered schools.[105] The DOE's 1998 report on *The Massachusetts Charter School Initiative* underscored the difficulty encountered by charter schools in securing funding for school facilities:

> Perhaps the single greatest challenge charter schools face, however, is a lack of access to capital for the acquisition, expansion, or improvement of adequate school facilities. Most schools have either already encountered or still face the problem of facilities that are too small, lack outdoor space or play areas, or are inadequate in other ways. This problem is made worse by the fact that commercial banks have been wary of lending even small amounts of money to these entrepreneurial schools.[106]

The charter school law prohibits Commonwealth charter schools from receiving state school building assistance funds[107] for school construction, reconstruction, or

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[104] M.G.L. c. 71, §89(q).

[105] See, for example, Abby R. Weiss, *Going It Alone: A Study of Massachusetts Charter Schools*, (Institute for Responsive Education, 1997), 14; *Innovation and Massachusetts Charter Schools*, (Rosenblum Brigham Associates for the Massachusetts Department of Education, 1998), 8; and *Charting a Clear Course* (Charter Friends National Network, 1999), 50.

[106] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 8.

[107] The School Building Assistance Act, originally enacted as Chapter 645 of the Acts of 1948, provides financial assistance to municipalities and regional school districts undertaking school building projects.

improvement work.[108] However, the state's budget for the 1999 fiscal year included funds for grants to support charter school leasing and construction of facilities.[109] (This grant program is discussed in more detail later in this section.)

Under the DOE's charter school regulations, charter applicants are required to provide the Board of Education with written documentation that the facilities to be used by the charter school are approved for use as a school by the building inspector in the municipality in which the building is located and have been inspected by the fire department of the municipality in which the facilities are located.[110] There are no legal or regulatory controls over the procurement procedures or contracting arrangements used by charter schools in leasing facilities.

The Office's review of 41 real property agreements provided to the Office by the 24 charter schools in this review showed that all 24 schools occupied leased facilities as of July 1998.[111] According to DOE records, 6,590 students attended school in these facilities during the 1998 fiscal year. Table 5 lists the 41 real property agreements for facilities occupied by the 24 schools during the period of September 1994 to July 1998.[112] In some cases, these agreements had been amended to change the lease payments, add space, or extend the lease term.

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[108] M.G.L. c. 71, §89(mm).

[109] Chapter 194 of the Acts of 1998.

[110] 603 CMR 1.05, (2)(f) and 2(g).

[111] The Boston Renaissance Charter School, which leased property at 250 Stuart Street from the Commonwealth, subsequently took steps to purchase the property. Section 304 of Chapter 43 of the Acts of 1997 authorized the Commonwealth to sell 250 Stuart Street to the school at full and fair market value, based on three independent appraisals; it also required the Inspector General to review and approve the appraisals and their methodology.

[112] As the table indicates, some facility leases expired and were replaced with new leases during this period; in other cases, schools occupied more than one leased facility.

Table 5. Charter School Real Property Agreements

School	Location	Lessee	Lessor	Lease Terms
Academy of the Pacific Rim	Hyde Park	Academy of the Pacific Rim Charter School	Roman Catholic Archbishop of Boston on behalf of Most Precious Blood Parish	July 1, 1997-June 30, 1999
Atlantis	Fall River	Atlantis Charter School Corporation	The John E. Boyd Center	July 19, 1995-July 10, 1997
		Atlantis Charter School		July 10, 1997-July 31, 2000
Benjamin Banneker	Cambridge	Benjamin Banneker Charter School	Roman Catholic Archbishop of Boston on behalf of Our Lady of Pity Parish	August 1, 1996-July 31, 1998
Benjamin Franklin	Franklin	Benjamin Franklin Classical Charter School, Inc.	Roman Catholic Archbishop of Boston on behalf of St. Mary's Parish	July 1, 1995-June 30, 1996; July 1, 1996-June 30, 1997; July 1, 1997-June 30, 2000
Boston Renaissance	Boston	Boston Renaissance Charter School, Inc.	Division of Capital Planning and Operations (now Division of Capital Asset Management and Maintenance)	April 1, 1995-July 30, 2004
Boston University	Granby	Boston University Residential Charter School	The Order of Friars Minor Conventual, Inc.	September 1, 1997-August 31, 2000
Cape Cod Lighthouse	Orleans	Cape Cod Lighthouse Charter School, Inc.	Hawthorn-Sonnet, Inc.	March 1, 1995-August 31, 2003
Chelmsford Public	Chelmsford	Chelmsford Public Charter School	Chinese Bible Church of Greater Lowell	March 15, 1996-June 30, 2001
City on a Hill	Boston	City on a Hill Charter School, Inc.	YMCA of Greater Boston	September 1, 1995-June 30, 2000
Community Day	Lawrence	Community Day Charter School	Community Day Care Center of Lawrence, Inc.	September 1, 1995-August 31, 1997; October 1, 1996-September 30, 2001
Francis W. Parker	Devens	Francis W. Parker Charter School	Government Land Bank	September 15, 1995-August 31, 1996; September 1, 1996-June 30, 1998

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Table 5: Charter School Real Property Agreements (continued)

School	Location	Lessee	Lessor	Lease Terms
Hilltown Cooperative	Williamsburg	Western Massachusetts Hilltown Cooperative Charter School, Inc.	The Brassworks Associates	July 1, 1995-June 30, 2000
Lawrence Family Development	Lawrence	Lawrence Family Development Charter School	Lawrence Family Development and Education Fund, Inc.	July 1, 1996-June 30, 1997; July 1, 1997-June 30, 1998
			Sisters of Notre Dame Education Center	September 1, 1997-June 30, 1998
Lowell Middlesex Academy	Lowell	Lowell Middlesex Academy Charter School	Middlesex Community College	July 1, 1995-June 30, 1996; July 1, 1996-June 30, 1997; July 1, 1997-June 30, 1998
Lynn Community	Lynn	Lynn Community Charter School	Washington Square Realty Trust	July 1, 1997-June 30, 2002
Marblehead Community	Marblehead	Marblehead Community Charter Public School, Inc.	Twenty-three Lime Street Trust	May 1, 1995-June 30, 2000
Martha's Vineyard	West Tisbury	Martha's Vineyard Public Charter School	Options in Education, Inc.	May 15, 1996-July 15, 1998
		Martha's Vineyard Charter School	GE Capital Modular Space	July 19, 1996-July 18, 1999
Neighborhood House	Dorchester	Neighborhood House Charter School, Inc.	Roman Catholic Archbishop of Boston on behalf of St. Mark's Parish	August 1, 1995-July 31, 1996; August 1, 1996-July 31, 1997
		Neighborhood House Charter School	Roman Catholic Archbishop of Boston on behalf of St. Mark's Parish	August 1, 1997-July 31, 1998

Table 5: Charter School Real Property Agreements (continued)

School	Location	Lessee	Lessor	Lease Terms
North Star Academy	Springfield	North Star Academy	Lessard Property Management, Inc.	August 1, 1996-September 30, 1998
Pioneer Valley Performing Arts	Hadley	Pioneer Valley Performing Arts Charter School	Town of Hadley	July 1, 1996-June 30, 1998
SABIS International	Springfield	SABIS International Charter School	City of Springfield	July 1, 1995-June 30, 2000
		I.S.M. Managing SABIS International Charter School	Arthur Building Systems, Inc.	July 17, 1996-July 16, 2000
		SABIS International Charter School	SABIS Educational Systems, Inc.	September 1, 1997-August 31, 2000
Seven Hills	Worcester	Seven Hills Charter School	Seven Hills Charter School, Inc.	Tenancy-at-will
Somerville	Somerville	Charter School of Somerville, Inc.	Roman Catholic Archbishop of Boston on behalf of St. Joseph's Parish	August 1, 1996-July 31, 1998
South Shore	Hull	South Shore Charter School	Hull Redevelopment Authority	September 1, 1994-June 30, 2000
			A.I.T. Realty Trust	July 1, 1996-June 30, 2000
			Donohue's Bayside Realty Corp.	July 1, 1996-June 30, 2000
			Giuseppe Bongarzone and Maria Bongarzone	July 1, 1997-June 30, 1998

Source: Real property agreements provided by the 24 charter schools.

Most schools – 20 of the 24 – occupied facilities leased from private entities; six leased facilities from public entities.[113] Five schools leased school buildings from the Roman Catholic Archbishop of Boston. Four schools leased facilities from non-profit corporations created to provide support to their schools. Other lessors included realty trusts, the YMCA of Greater Boston, the Order of Friars Minor Conventual, Inc., the Government Land Bank, Middlesex Community College, and two municipalities. As

[113] Two schools, SABIS International Charter School and South Shore Charter School, had executed multiple leases with both private entities and public entities.

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Table 5 shows, the lessees for facilities used by seven of the 24 schools between March 1995 and July 1998 were not the schools themselves; in each case, the private non-profit corporation established to provide support to the school was the lessee, although the school paid the rent or occupancy charges under the lease agreement.[114] Documents provided to the Office by the schools indicated that the schools had not executed written sublease agreements with the private non-profit corporations leasing the facilities.

For each school in this review, the lease costs listed in the lease agreements themselves were adjusted to a fiscal year basis to derive the lease costs shown in Table 6. Table 6 also shows these adjusted lease costs as a percentage of total school expenditures for each fiscal year. As Table 6 shows, the lease costs of the 24 charter schools in this review exceeded $3 million in the 1998 fiscal year. The lowest expenditure for the 1998 fiscal year was $40,000; the highest was $583,600. For all schools, lease costs as a percentage of total school expenditures totaled approximately seven percent in the 1998 fiscal year.[115] For individual schools, lease costs as a percentage of total school expenditures ranged from four percent to 14 percent in the 1998 fiscal year.

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[114] In addition to the seven schools referenced above, the Office's review disclosed that SABIS International Charter School made payments on a modular building lease between I.S.M. Managing SABIS International Charter School and Arthur Building Systems, Inc. The modular building was located on land leased by the school from the City of Springfield. Charter schools are subject to M.G.L. c. 149, §44E, which requires public agencies to conduct an advertised proposal process for procurements of modular buildings and components of buildings. The Office's review did not establish whether the school's procurement from Arthur Building Systems was subject to and conducted in accordance with M.G.L. c. 149, §44E.

[115] In response to a draft version of this report, the DOE Commissioner noted that charter school lease costs amounted to approximately 5.7 percent of their total revenues in the 1998 fiscal year.

Table 6. Charter School Lease Costs

School	Total Lease Cost ($)			Lease Cost as a Percentage of Total School Expenditures			Lease Cost per Student ($)		
	FY96	FY97	FY98	FY96	FY97	FY98	FY96	FY97	FY98
Academy of the Pacific Rim			80,000			10			811
Atlantis	120,000	120,000	180,000	9	6	7	547	356	430
Benjamin Banneker[a]		154,000	154,000		7	6		791	612
Benjamin Franklin Classical	58,600	83,375	97,775	9	9	8	393	421	384
Boston Renaissance[b]	175,000	275,000	362,500	1	3	4	284	260	338
Boston University			58,840			5			5,025
Cape Cod Lighthouse[c]	105,993	168,571	175,207	15	15	14	829	1,042	1,065
Chelmsford Public		50,000	50,000		6	5		325	287
City on a Hill[d]	33,600	72,448	76,800	6	7	5	517	735	542
Community Day	15,000	95,535	121,380	2	10	8	137	724	619
Francis W. Parker	18,890	48,668	133,133	2	4	7	158	263	532
Hilltown Cooperative	24,000	27,600	40,860	12	10	7	615	501	562
Lawrence Family Development[e]	0	148,740	156,992	0	9	7	0	629	530
Lowell Middlesex Academy[f]	54,200	67,410	70,780	12	10	9	642	674	683
Lynn Community			135,000			11			935
Marblehead Community[g]	60,000	70,000	78,000	6	6	6	441	409	445
Martha's Vineyard[h]		77,500	102,000		12	10		1,034	981
Neighborhood House	40,750	91,375	103,860	10	10	8	801	880	829
North Star Academy		37,870	60,903		8	7		539	559
Pioneer Valley Performing Arts		35,000	40,000		8	4		554	300
SABIS International	33,600	370,600	583,600	1	11	11	75	618	780
Seven Hills[i]		n/a	304,895		–	7		–	461
Somerville[j]		149,692	163,300		5	4		335	300
South Shore[k]	0	101,000	116,400	0	5	5	0	312	343
Total	**$749,633**	**$2,244,384**	**$3,446,225**						

Source: Lease documents provided by the charter schools to the Office. It should be noted that lease amounts have been adjusted to reflect fiscal year lease costs. Expenditure calculations are based on expenditures reported in the schools' audited financial statements. Costs per student are based on enrollment data provided by the DOE.

[a] Lease cost included a $65,000 per year credit for building upgrades.

[b] Lease cost did not include payments on a $12.2 million renovation loan.

[c] Lease cost included common area maintenance fees.

[d] Lease cost included utilities, but did not include buildout costs.

[e] Lease cost did not include buildout costs.

[f] Lease cost included utilities.

[g] FY96, FY97, and FY98 audited financial statements reported higher lease costs.

[h] Lease cost included modular classroom rental costs.

[i] FY97 lease cost included $33,600 for school building plus $337,000 for two years prepaid rent for modular buildings. FY98 lease cost included $33,600 for school building and $550,000 for land and buildings.

[j] The school provided no lease documents to the Office. The FY98 cost list in Table 6 was reported as an "occupancy charge" in the school's FY98 audited financial statements. The FY97 audited financial statements contained no information on occupancy charges.

[k] FY97 and FY98 audited financial statements reported higher lease costs.

[l] FY96, FY97, and FY98 audited financial statements reported higher lease costs.

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It should be noted that the lease costs of the 24 schools are not comparable. As the footnotes to Table 6 show, some leases included additional costs such as utility costs; others did not. In addition, many leases were likely to have entailed construction buildout;[116] buildout costs were not specified in the lease documents.

According to the annual reports prepared by the schools and site reports prepared by the DOE, there were significant variations in the type, quality, and adequacy of the facilities leased by the 24 schools in 1997 and 1998. Some schools that lacked gymnasiums contracted with private athletic facilities for physical education programs. Some schools reported that they lacked laboratory and library space.

According to DOE records, DOE teams conducted site visits to 21 of the 24 schools in this review between October 1997 and June 1998. The site visit reports documented the teams' responses to a series of questions regarding the schools, including the following question regarding school facilities: "Are the physical facilities adequate for the program of the school?" Of the 21 schools, the site visit teams concluded that the facilities used by 14 schools were adequate for their current needs, but that seven of the 14 schools would soon outgrow their facilities. The teams also identified seven schools whose physical facilities were inadequate for their current needs.

Finding 15. Charter schools' unadvertised, noncompetitive real property transactions are vulnerable to waste and abuse.

Most state and local entities in Massachusetts, including Horace Mann charter schools, are required by state law to conduct an advertised competition for the purchase or lease of real property.[117] Although they are permitted under some circumstances to acquire

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[116] The term "buildout" refers to any construction, alteration, or other improvements to leased space.

[117] State agencies are subject to M.G.L. c.7, §§40E-40L, which requires advertising and competition for most state real property transactions. Cities, towns, regional school districts, and Horace Mann charter schools are subject to M.G.L. c. 30B, §16, which requires an advertised request for proposals process for real property transactions with a cost or value of more than $25,000.

real property without competition on the basis of the property's unique qualities or location, these transactions are subject to public disclosure requirements.[118]

Commonwealth charter schools spend millions of dollars each year to rent their facilities. However, real property transactions by Commonwealth charter schools are not subject to any law or regulation requiring advertising, competition, or public disclosure. The absence of effective controls over charter schools' real property transactions increases the risks of waste and abuse in the expenditure of public funds for facility leases.

According to officials of the DOE's charter school office, the DOE has provided little specific guidance to charter school applicants on facility acquisition methods. Instead, charter school applicants have been expected and encouraged to develop their own methods of locating space and negotiating lease agreements. Thus, although most charter school applicants reportedly devote substantial time and effort to locating suitable charter school facilities, they are not required or expected to advertise for facilities or use any other market-based methods of acquiring school facilities.

When charter schools apply to the DOE for charter renewal, the schools are required under DOE regulations to submit documentation that they remain in compliance with all building, health, safety, and insurance requirements, and that all related inspections and approvals are current.[119] However, neither the regulations nor the DOE's charter renewal application require the schools to demonstrate that their facility costs are within a reasonable range, given existing market conditions. Schools that elect to remain in

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[118] For example, a local school district may determine that the qualities or location of a vacant private school building are uniquely suited to its requirements and that advertising will not benefit the school district's interest. When such a determination can be made, the school district may use the unique acquisition provision contained in M.G.L. c. 30B, §16(e)(2). Under this provision, the school district must make a written determination of these findings; the school district must also publish the determination and the reasons for its determination, the names of the parties having a beneficial interest in the property, the location and size of the property, and the proposed purchase price or rental terms.

[119] 603 CMR 1.11(4).

their current locations may be vulnerable to unwarranted rent increases. Schools that renew or extend their existing leases with no change in price may also pay more than necessary for their facilities if their payments during the first five years included significant buildout costs.

The competitive forces of the private marketplace can be an effective tool in leasing real property. Soliciting competitive proposals may help to attract prospective landlords, foster price competition, and provide assurance that the lease price of the selected facility is within a reasonable range. Advertising and disclosure of the transaction also serve the objective of public accountability. Conversely, noncompetitive, unadvertised, negotiated real property transactions undermine the objectives of cost-effective, accountable lease arrangements. The risks of waste and abuse may be heightened when the real property transactions take place between related parties, as discussed below.

Six charter schools leased their facilities from related parties or organizations.

The Office's review of the facility leasing arrangements and the audited financial statements of the 24 schools in this review disclosed six schools that leased their facilities from related parties or organizations. Under the definition of "related party" used by Massachusetts law regulating the activities of public charities, a "related party" would include the following individuals:

1. An officer, director, or trustee (or an individual having powers or responsibilities similar to those of officers, directors, or trustees) of the school;

2. An employee of the school who has management responsibilities for achieving the objectives of the school and who is authorized to establish policies or make decisions by which those objectives are achieved;

3. A spouse, child, grandchild, sibling, parent or grandparent of parties described in (1) and (2) above; and

4. A corporation, trust, estate, or partnership more than 15 percent of which is held by any of the parties described in (1), (2), and (3) above.[120]

Similarly, a "related organization" would be defined as any entity (whether non-profit or for-profit):

- which the school directly or indirectly controls, or
- which directly or indirectly owns or controls the school, or
- a purpose of which is to benefit or further the purpose of the school, or
- which the school is established to benefit or further its purposes.[121]

Related-party transactions pose risks to any organization, whether public or private. The Financial Accounting Standards Board *Accounting Standards* require disclosure in financial statements of material related-party relationships. According to the *Standards*:

> Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated.[122]

Because related-party transactions increase the potential for conflicts of interest, these transactions are regulated by the Commonwealth. Related-party transactions involving public charities in Massachusetts are subject to strict disclosure requirements; related-party transactions involving public employees in Massachusetts are regulated and restricted by the conflict of interest law, M.G.L. c. 268A. The Commonwealth has adopted some additional measures designed to reduce the risks to state interests posed by related-party transactions undertaken by private contractors: state regulations restrict the circumstances under which the Commonwealth may reimburse a private

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[120] Office of the Attorney General, Massachusetts Division of Public Charities, Form PC.

[121] Ibid.

[122] *Accounting Standards*, 1994/95 Edition, Current Text, Volume I, 38346.

contractor for a related-party transaction and prohibit any reimbursement that exceeds the market price of the transaction.[123]

Table 7 lists the schools that reportedly leased their facilities from related parties and organizations. A related-party transaction does not necessarily mean that the related party has received unwarranted benefits at the expense of the school. The Office did not undertake a market analysis of the specific leasing arrangements of the schools listed in Table 7. In general, however, unadvertised, negotiated related-party transactions are especially vulnerable to waste and abuse.

By funding noncompetitive, negotiated facility costs, the Commonwealth's $2.8 million facility grant program for charter schools will not promote best value leases.

Under the $2.8 million charter school facility grant program authorized by the Legislature for the 1999 fiscal year, charter schools may apply to the DOE for facility-related grants[124] totaling $270 per student, based on their annual 1998-1999 school enrollments. According to the DOE's 1998 grant program guidelines, the purpose of this grant program was:

> to provide charter schools with a one-time grant allocation for annual costs associated with the purchase, leasing, renovation and/or construction of charter school facilities.

According to DOE officials, charter schools may use the grant funds to defray their facility-related costs, such as lease payments, renovation costs, or construction costs. With respect to grant expenditures, the DOE guidelines stated:

> Charter schools may use the grant for expenses associated with the purchase, leasing, renovation or construction of the school facilities and for the implementation of the charter granted by the Commonwealth. Grant should be used to cover facility or capital costs budgeted for FY99. Funds may be used to cover new spending or to retire facility-related debt.

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[123] 808 CMR 1.05(8).

[124] Charter school planning and development costs were also eligible for grant funds from the $2,847,290 budget appropriation.

Table 7. Charter School Related-Party Leases

School	Lessor	Lessor Relationship to School	Information Source
Atlantis Charter School	John E. Boyd Center	The President of the Center served as a member of the school's Board of Trustees. (The 1998 disclosure of financial interest filed with the DOE by the Trustee stated that she did not participate in decisions, votes or other matters relative to the school and the Center.)	FY96, FY97, and FY98 audited financial statements; 1998 disclosure of financial interest
Community Day Charter School	Community Day Care Center of Lawrence, Inc. (CDCCL)	The Executive Director of CDCCL also served as the Executive Director of the school.	FY96, FY97, and FY98 audited financial statements
Lawrence Family Development Charter School	Lawrence Family Development and Education Fund, Inc. (LFDEF)	Members of LFDEF's Board of Trustees also served on the school's Board of Trustees.	FY96, FY97, and FY98 audited financial statements; FY96 and FY97 Division of Public Charities, Form PC - Annual Reports
Lowell Middlesex Academy Charter School	Middlesex Community College	The President of Middlesex Community College also serves as President of the school's Board of Trustees.	FY96, FY97, and FY98 annual reports; School by-laws
Martha's Vineyard Public Charter School	Options in Education, Inc. (OIE)	OIE's President and Treasurer have both served as members of the school's Board of Trustees.	FY98 audited financial statement; 1998 disclosures of financial interest
Seven Hills Charter School	Seven Hills Charter School, Inc.	Members of the Board of Trustees of Seven Hills Charter School, Inc. also served on the school's Board of Trustees.	FY97 and FY98 audited financial statements

DOE officials stated that the DOE is not required to review the reasonableness of the lease payments to be funded by the grant, nor to verify that any renovation or construction work funded by the grant is conducted in accordance with state construction bid laws.

The Office does not question the policy decision to devote additional state funds to assisting charter schools with facility-related costs. However, there is reason to question the wisdom of permitting charter schools to continue spending millions of dollars in state funds on unadvertised, negotiated – and in some cases, unwritten – real estate leases. The risks of waste and abuse are increased by the prevalence of

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related-party transactions in this area. The facility grant program channels additional state funds to this vulnerable area of procurement and contracting without requiring increased accountability.

In an interview, DOE officials pointed out that requiring the grant funds to be spent on competitively awarded leases would not be practical, since most schools have existing leases that will not expire until the end of their charters. The impracticality of instituting competitive requirements after leases have been executed reinforces the importance of requiring charter schools to use market-based leasing methods before executing leases and other real property transactions.

Finding 16. Some facility information provided to the DOE in the charter school applications has proved speculative and unreliable.

Under the charter school law, the Board of Education is required to solicit information in the charter application on each charter applicant's plans for providing school facilities.[125] The DOE's charter school regulations include the following criteria for assessing and approving a charter application:

> [D]emonstration that the applicant has access to school facilities that are in compliance with municipal building codes and other applicable laws; affordable; and adequate to meet the school's program requirements.

However, the DOE's *Application for a Public School Charter* solicited no information on the cost or affordability of the applicant's proposed facility. The application solicited the following facility-related information:

9. Facilities and Student Transportation

A. Describe the viable options for a facility for this school.

B. Why were these sites chosen?

C. What renovations might be required? How might the renovations be financed?

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[125] M.G.L. c.71, §89, (f)(9).

D. Describe the transportation services that the school will provide to eligible students.

In an interview, DOE officials acknowledged that the DOE's evaluation of charter applicants does not include a determination of whether the facilities proposed by a charter school applicant are affordable.

In addition, the Office's review revealed that only 14 of the 24 schools in this review ultimately used the specific school facilities identified in their charter school applications to the DOE. Of the remaining 10 schools, five had not proposed specific facilities in their applications; rather, they had proposed geographic areas within specific school districts and had opened their schools within those school districts. The other five applicants had proposed specific facilities but had opened their schools in facilities other than those proposed to the DOE.

For example, the February 1995 application filed with the DOE for the Academy of the Pacific Rim Charter School stated that the school facility would be colocated with Don Bosco Technical High School, a private school near the Chinatown area in Boston. The application stated, in part:

> The location was chosen based on its proximity to Boston's strong Asian community and to business, educational, and cultural resources that will be incorporated into the Academy's program.

However, in July 1997 the school entered into a lease with the Roman Catholic Archbishop of Boston on behalf of Most Precious Blood Parish for a former Catholic school building in the Hyde Park area of Boston, far from the Chinatown location proposed in the school's charter application. Whatever the school's reasons for the change of location, this example illustrates the speculative nature of the facility information solicited by the DOE and its limited utility as a basis for planning and evaluation.

According to DOE officials, the DOE's evaluation focuses on a charter applicant's likelihood of obtaining an appropriate facility. They stated that an applicant that appears to have access to an appropriate facility would receive a high rating on this criterion, as

would an applicant that has developed a credible plan for acquiring an appropriate facility. DOE officials also stated that the proposed school opening date also affects the weight given to specific facility information: if the proposed schedule includes substantial lead time to locate an appropriate facility, the DOE will not penalize the applicant for failing to specify the facility to be used for the school.

In view of the difficulty encountered by charter applicants in locating school facilities before being awarded a charter and the speculative nature of the facility information provided in the charter applications, there would appear to be no compelling reason to require specific facility information in the charter application. Indeed, this requirement may serve to undermine the charter application process by unnecessarily discouraging charter applicants who have not yet located a facility while favoring those who have located a facility, but may ultimately be unable to secure a lease for the same facility. Deferring the final selection of a facility until after the charter is awarded would also enable the newly chartered school to conduct an advertised, competitive leasing process in the months after the charter award.

Finding 17. Charter schools have not complied with the beneficial interest disclosure requirements contained in M.G.L. c. 7, §40J.

Charter schools, like other public entities in Massachusetts, are required to comply with the disclosure requirements of M.G.L. c.7, §40J for all real property transactions. Under this law, public agencies are required to disclose all beneficial interests in real property rental, sale, or purchase agreements. The disclosure of the names and addresses of all individuals with beneficial interests in the property must be filed with the Division of Capital Asset Management and Maintenance (DCAMM). Specifically, the law states:

> No agreement to rent or to sell real property to or to rent or purchase real property from a public agency, and no renewal or extension of such agreement, shall be valid and no payment shall be made to the lessor or seller of such property unless a statement, signed, under the penalties of perjury, has been filed by the lessor, lessee, seller or purchaser, and in the case of a corporation by a duly authorized officer thereof giving the true names and addresses of all persons who have or will have a direct or indirect beneficial interest in said property with the commissioner of capital asset management and maintenance.

In the case of an agreement between a public agency and a private corporation, the names and addresses of individuals with an ownership interest of 10 percent or more must be disclosed. An updated disclosure must be filed within 30 days of any change in beneficial interests during a lease term. These disclosures must be made available for public inspection.

The intent of this disclosure law is to reduce the potential for conflicts of interest and corruption in real property transactions. In its 1980 report to the Legislature, the Special Commission Concerning State and County Buildings provided the following rationale for the disclosure requirements contained in M.G.L. c. 7, §40J:

> Through this provision the Commission hopes that cases in which "straws" are used to purchase property and any apparent instances of favoritism in real property transactions will be minimized.[126]

As of January 1999, none of the required disclosures of beneficial interests for the 41 leases executed by the schools in this review had been filed with DCAMM.[127] The only disclosure relating to charter schools that had been filed with DCAMM was a disclosure of beneficial interests pertaining to the Boston Renaissance Charter School, Inc., a private foundation that leases property from DCAMM under a joint arrangement with Boston Renaissance Charter School.[128] In an interview with the Office, DOE officials stated that the DOE had not provided information to charter schools regarding their obligation to comply with the disclosure of beneficial interests requirement contained in M.G.L. c.7, §40J.

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[126] Special Commission on State and County Buildings, *Final Report to the General Court*, Volume 7 (1980), 126.

[127] According to DCAMM, the facility leases held by private non-profit entities acting on behalf of charter schools are also subject to M.G.L. c. 40J.

[128] In August 1998, the Boston University Residential Charter School provided the Office with a copy of a public notice of the school's unique acquisition of property from the Order of Friars Minor Conventual, Inc. The notice, which had been submitted to the *Central Register* in September 1997, disclosed the private entities with a beneficial interest in the property. However, this disclosure did not appear to have been filed with DCAMM.

VIII. Conclusion and Recommendations

The findings summarized in this report focus exclusively on the business policies and practices of the 24 Massachusetts charter schools in this review. Consistent with the legislative directive contained in Chapter 46 of the Acts of 1997, the foregoing sections of this report have examined several areas of charter school business operations, including contracting practices, financial controls, and procurement procedures.

To date, charter school business operations have received little scrutiny. Both nationally and within Massachusetts, the debate over the charter school movement has focused primarily on educational effectiveness. The philosophy of the charter school movement is that charter schools should be free to use whatever means and processes they choose as long as the educational results are satisfactory.[129] Massachusetts charter schools are monitored and overseen by the state Department of Education (DOE), which is empowered to award, renew, and revoke their charters. According to the DOE's 1998 report on the Massachusetts charter school initiative, charter schools are evaluated primarily on the basis of the academic progress of their students.[130]

While charter schools are required to comply with some of the same laws and regulations – such as health, safety, and antidiscrimination laws – that apply to other public schools, charter schools are not subject to the same legal rules governing their business operations. Unlike other public schools in Massachusetts, charter schools are not required to procure supplies, services, and real property using the competitive procedures of M.G.L. c. 30B. In addition, charter schools are permitted to incur short-term debt without being subject to the legal restrictions on borrowing by Massachusetts cities and towns.

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[129] See Manno, Finn, Bierlein, and Vanourek, "Charter School Accountability: Problems and Prospects," *Charter Schools in Action Project Final Report*, Part IV, Hudson Institute, August 1997.

[130] Massachusetts Department of Education, *The Massachusetts Charter School Initiative* (1998), 18.

This report has identified weaknesses in the contracting practices, internal controls, and procurement procedures of many charter schools in this review. If left uncorrected, these weaknesses are likely to undermine the schools' ability to achieve their educational objectives; they also jeopardize the interests of state taxpayers whose dollars fund those schools. For example, four charter schools contracting for comprehensive educational services have executed contracts that contained no contractor performance requirements measuring students' academic performance. Five charter schools have executed contracts with private management contractors containing unfavorable compensation provisions posing unwarranted risks to the interests of the schools. Two charter schools have incurred substantial interest charges by deferring payment of fees owed to their management contractors from year to year; these same schools have borrowed funds from their management contractors without written loan agreements specifying the interest rate and repayment schedule. Such contracting practices do not serve the interests of charter school officials, students, or parents, nor of the state taxpayers who fund charter schools.

In addition, the Office found that 13 of the 24 charter schools in this review had no written procedures governing their procurements of supplies, services, or equipment. Five charter schools have been repeatedly criticized by their independent auditors for failing to institute basic business controls such as detailed budgets or accounting manuals.

These findings may be attributable in part to inadequate administrative resources. Individuals with the necessary talent, expertise, and dedication to design and implement innovative educational methods do not necessarily possess the necessary expertise, time, and motivation to develop effective internal control systems and procurement procedures. Although the DOE has informed charter schools that they are obligated to follow sound business practices – including the adoption of written procurement procedures that maximize competition – as conditions of their charters, the DOE has not taken steps to monitor compliance with these requirements.

In theory, the DOE's authority to revoke or deny renewal of charters to schools whose operational or financial viability is judged inadequate provides a sufficient incentive for charter schools to institute sound business practices. This theory remains largely untested: as of October 1999, the DOE had neither revoked nor denied renewal of any charters. However, the fact that the DOE's charter renewal criteria do not entail an explicit evaluation of charter schools' business practices may have reduced the likelihood that charter schools would devote scarce resources to this area of operations.

It has also been argued that the strict budgetary limitations imposed on charter schools by the state's tuition formula provide the necessary safeguards against wasteful or inappropriate charter school expenditures. However, the Office's review revealed that some charter schools are not operating within these budgetary restrictions; instead, they have incurred substantial debts in order to supplement their state tuition payments and other sources of income. The Commonwealth could, in some circumstances, be liable for the outstanding financial obligations of these schools if the DOE revoked or failed to renew their charters. Thus, the financial exposure of these charter schools could pose significant risks to state taxpayers. If the current cap of 37 Commonwealth charter schools is increased or removed, and the number of Commonwealth charter schools increases, the outstanding financial obligations of these schools – and corresponding risks to state taxpayers – will escalate further.

Efficient, cost-effective business practices that reduce the risks of waste and abuse will further a charter school's educational mission. Conversely, inefficient business practices that invite waste and abuse will consume resources that could and should be devoted to improving the educational performance of the charter school's students. Strengthening charter school business operations is therefore in the interests of all charter school stakeholders: the schools themselves, parents, students, and state taxpayers.

Accordingly, the recommendations provided at the end of this section are aimed at accomplishing this objective by implementing two policy initiatives: best value

contracting and proactive oversight. These initiatives are discussed in further detail below.

Best Value Contracting

A central premise underlying the charter school initiative, nationally as well as in Massachusetts, is that a market-driven educational system will promote innovation, efficiency, and accountability on the part of charter schools as well as regular school systems. Despite the competitive model on which charter schools were founded, the charter school movement has not taken the lead in applying similar market principles to charter schools' business transactions, nor has this issue been a focus of the charter school literature.

The decision to contract out public functions to the private sector is a policy decision that may entail value judgments and accountability considerations as well as efficiency and cost analyses. However, when a charter school – or any other public entity – does decide to contract with the private sector, it should do so in an accountable manner that obtains the best value for the public dollar by taking into consideration its quality and performance objectives as well as price. The strategy of fostering competition in the private marketplace on the basis of quality, performance, and price is commonly referred to as "best value contracting." Competition is a key element of best value contracting. Research has consistently demonstrated that without the discipline of the competitive marketplace, contracts for supplies and services with the private sector are neither efficient nor cost-effective.

As noted above, the DOE has instructed charter schools to develop competitive procurement procedures. However, only two of the 24 schools in this review had developed written procedures requiring advertised competition. This finding suggests that the current approach of encouraging each charter school to invent its own procurement procedures is unlikely to result in accountable procurements that promote best value contracting.

Since the enactment of M.G.L. c. 30B in 1990, more than 1,500 local jurisdictions in Massachusetts – including local and regional school districts – have conducted best value procurements for their supplies, services, and real property acquisitions.[131] Horace Mann charter schools are also subject to the requirements of M.G.L. c. 30B. Thus, most vendors serving Massachusetts public schools are familiar with M.G.L. c. 30B and accustomed to competing for school contracts. Charter school procurement officers are already required to participate in the Massachusetts Certified Public Purchasing Official (MCPPO) program, which offers three seminars on best value contracting. As of November 1999, representatives of 21 Commonwealth and Horace Mann charter schools throughout Massachusetts had attended or made arrangements to attend at least one MCPPO seminar. Three Commonwealth charter schools in this review advised the Office that they already use M.G.L. c. 30B to procure supplies and services. For all of these reasons, the most efficient means of ensuring best value contracting by charter schools is to require them to use the widely accepted and well-documented competitive procedures of M.G.L. c. 30B.

Some private management contractors providing comprehensive educational and administrative services to Massachusetts charter schools are selected by the charter school founders before the schools are chartered. To address these circumstances, the recommendations at the end of this section would exempt these management contracts from the competitive requirements of M.G.L. c. 30B in cases where the management contractor was selected prior to and included in the original charter application. In these cases, the DOE would be responsible for conducting a full assessment of the management contractor's qualifications and price to provide the services specified in the application.

Otherwise, this report recommends that each charter school electing to contract with a private management contractor for educational and administrative services – or for administrative services exclusively – be required to develop a detailed scope of work,

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[131] State agencies are also required to use best value contracting methods for purchases of supplies and services and for real property transactions.

including performance standards and requirements, for the services to be procured; conduct an advertised competition; evaluate and compare offers from qualified contractors; and select the best offer.[132] This market-driven approach to contracting for management services would increase the likelihood of obtaining high-quality services on favorable terms.[133] While incumbent management contractors may prefer not to be required to compete for charter school contracts,[134] the prospect of initial vendor resistance should not deter charter schools, the DOE, and the Legislature from promoting competition and accountability through best value contracting.

Proactive Charter School Oversight

Charter school proponents on the national level have begun to recognize the need to shore up the business side of charter school operations if the charter school movement is to survive over the long term. For example, the Hudson Institute, whose "Charter Schools in Action" project generated two major reports on its research on charter schools in 14 states, including Massachusetts, has cited the "lack of business acumen and managerial competence" as a start-up problem that charter schools themselves need to address. In a 1997 report chapter entitled "Charter School Accountability: Problems and Prospects," the Hudson Institute noted:

> Charter founders are often dreamers and visionaries, less often veterans of meeting payrolls, balancing budgets, designing benefits packages, negotiating contracts, following due-process rules, and filling out forms for state and federal categorical [grant] programs. Yet to succeed, charter schools must be competent in all those areas and more. . . . We never expected to say this – critics as we generally are of school-system

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[132] Under M.G.L. c. 30B, educational programs may, under some circumstances, be procured without advertising and competition under the sole-source procurement provision of the law.

[133] *Charting a Clear Course*, the June 1999 charter school resource guide published by the Charter Friends National Network, encourages charter schools to shop around for service providers that will meet their needs and specifications.

[134] In a 1996 *Public Integrity Annual* article entitled "Privatization and Cozy Politics," Kobrak noted: "While competition is good for the economy as a whole, individual companies understandably seek to insulate themselves from it. To the extent that they succeed, reality becomes distinctly at odds with orthodoxy."

bureaucracies – but some charter schools are simply under-administered.[135]

To strengthen charter schools' business operations, the second policy initiative recommended in this report is an effective and reliable system within the DOE for conducting proactive oversight. The starting point for this system is the DOE's charter school application process, which should enable the DOE to conduct a meaningful evaluation of the administrative and financial capacity of charter school applicants. The Accountability Plan developed by newly chartered schools should include a business plan for the school's operations and finances. There is no evidence that Massachusetts charter schools have developed innovative administrative systems or procedures that are worthy of replication.[136] Rather, the evidence indicates that many Massachusetts charter schools, like the charter schools studied by the Hudson Institute, are underadministered. Thus, as part of its oversight function, the DOE should provide assistance to new and existing charter schools to facilitate the adoption of sound business systems and practices. To ensure genuine accountability, the DOE must also establish reliable methods of monitoring each school's financial condition, internal control systems, and compliance with its business plan.

Although the Massachusetts charter school law is considered a strong state oversight model on a national level,[137] the oversight requirements of the law have not been fully or effectively implemented. The DOE has recently taken steps to improve its charter school oversight function. However, notwithstanding the evident dedication of the two

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[135] Manno, Finn, Bierlein, and Vanourek, "Charter School Accountability: Problems and Prospects," *Charter Schools in Action Project Final Report, Part II*, (Hudson Institute,1997), 9.

[136] *Innovation & Massachusetts Charter Schools*, a 1998 consultant study by Rosenblum Brigham Associates commissioned by the DOE, identified innovative practices in areas such as academic curriculum focus, assessment practices, professional development, school climate, and family and community involvement; however, the study identified no significant innovations relating to charter school business operations.

[137] See, for example, Priscilla Wohlstetter and Noelle C. Griffin, "First Lessons: Charter Schools as Learning Communities," *CPRE Policy Briefs* (Consortium for Policy Research in Education, 1997), and Lynn Schnaiberg, "Charter Schools Struggle With Accountability," *Education Week* (June 10, 1998).

professional staff members of the DOE's charter school office, the charter school office has lacked sufficient staff resources to provide effective, proactive oversight of the business operations of Massachusetts charter schools.

In addition to managing a formidable workload with inadequate staff resources, the DOE's charter school office must balance the dual pressures of providing assistance to charter schools while evaluating their performance. How much state assistance and evaluation are sufficient to safeguard the public interest? This is a legitimate policy question that deserves discussion and debate.

The recommendations provided below would benefit the charter school community and state taxpayers by improving DOE oversight in at least three areas. First, the DOE would ensure that newly chartered schools possess sufficient resources and information to institute and administer sound business policies and practices. Deficient business operations and noncompetitive procurement methods are unlikely to improve charter schools' educational outcomes.

Second, the DOE would identify and address operational problems at charter schools before these problems become insurmountable. Even charter school advocates within the research community have raised legitimate concerns about the appropriateness of relying on the chartering agency's ability to shut down a school as the primary tool for holding schools accountable. For example, the Hudson Institute has argued for an early intervention program for charter schools:

> Some [charter school] failures will occur for educational reasons, others because of management, governance, fiscal, or business difficulties. (Most closings so far have involved financial problems.) Although we view this prospect with equanimity, there is no denying that the public-relations fallout may be heavy. Opponents are eager to exploit these cases as evidence that the entire charter movement is too risky. In any case, **closing schools down is so drastic a step that in reality it will seldom be used as the main line of accountability** . . . .
>
> In our view, states have not paid enough attention to less draconian steps by which a faltering charter school might be warned or healed. If the death penalty is the only sentence available, a lot of crimes will go unpunished – and perhaps some needless deaths will occur. One might

> suppose, therefore, that states would be preparing for this eventuality. Yet we have not found a single jurisdiction with a well-formed plan for dealing with problem schools or outright failures. Few even have an adequate monitoring program to pick up early warnings of schools in trouble.[138] [Emphasis added.]

And third, the DOE would ensure genuine administrative accountability by holding all charter schools to clear standards of financial and operational performance. By the time a charter school applied for renewal, the DOE would have compiled full information on the school's operations and track record.

This policy initiative will require the Commonwealth to increase its investment in charter school oversight. The DOE's charter school office will require additional staff resources in order to fulfill its current oversight responsibilities and to implement the recommendations listed below.

Recommendations

The Inspector General recommends the following measures to strengthen the Massachusetts charter school initiative, increase charter school accountability, and protect the public's investment in charter schools:

1. **The DOE should strengthen and systematize its oversight of charter schools' business operations and financial condition.**

The DOE has informed charter schools that they must follow sound business practices as a condition of their charters. To monitor compliance with this requirement and increase accountability, the DOE should develop clear standards and systematic procedures for monitoring charter school performance in key operational areas.

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[138] Manno, Finn, Bierlein, and Vanourek, "Charter School Accountability: Problems and Prospects," *Charter Schools in Action Project Final Report, Part IV* (Hudson Institute, 1997), 10.

2. **The DOE should require each charter applicant to submit a detailed business plan for administering the school's operations and finances.**

The DOE should develop and disseminate to charter applicants a detailed outline of the business plan as well as a mandatory checklist of the plan contents. Vague or incomplete business plans should be rejected or returned to the applicants for supplementation. For example, the business plan should include detailed information on the number, qualifications, and duties of the key administrative personnel who will be responsible for managing the school's business operations. If an applicant proposes to contract with a private entity to manage the school's educational and/or business operations, the applicant should be required to provide detailed information on the private contractor's qualifications for both types of services, the "due diligence" conducted by the applicant prior to selecting the contractor, the terms of the proposed contract, and the applicant's plan for monitoring and evaluating the contractor's performance. After receiving approval from the DOE, the business plan of each newly chartered school should be incorporated into the school's Accountability Plan and used by the DOE as a monitoring tool.

3. **Charter schools should be required to use the competitive procedures of M.G.L. c. 30B to procure supplies and services, and to acquire and dispose of real property.**

Charter school contracts with private entities for comprehensive educational and/or administrative services should be exempted from these competitive requirements only when the private entity has been evaluated by the DOE in the charter application process. Other contracts for supplies and services should be awarded using the best value contracting methods of M.G.L. c. 30B.

Similarly, charter school leases and other real property transactions should be subject to the advertising and disclosure requirements of M.G.L. c. 30B. The DOE's charter application process should be amended to accommodate this recommendation. Rather than soliciting speculative information from charter school applicants on the facilities they hope to occupy, the DOE's application should instead require charter applicants to identify the geographic area in which the proposed school will be located and provide a

realistic timetable for conducting a competitive procurement of rental space. Upon being awarded a charter, the newly-chartered school would then advertise for competitive proposals under M.G.L. c. 30B, §16.

4. The DOE should provide charter schools with comprehensive information on their legal obligations.

Although charter schools are currently not subject to the requirements of M.G.L. c. 30B, they are subject to certain other laws, including the state's construction bidding laws, public records law, and conflict of interest law. These laws are no less binding on charter school trustees and staff who may be unaware of their legal obligations. Those charter schools that are unaware of their obligations should immediately obtain the necessary legal information and guidance. Either each charter school should individually seek legal counsel on these issues, or the DOE should provide all charter schools with the necessary information. The latter approach requires a higher investment of DOE resources but appears more efficient and cost-effective for charter schools as a group.

The DOE should also disseminate information from the State Ethics Commission regarding the obligations of charter school trustees and employees under M.G.L. c. 268A, the conflict of interest law. Charter school trustees should be required to receive training by the State Ethics Commission in the applicable requirements of the law. The State Ethics Commission conducts ethics seminars for public officials on request. In addition, the Public Contracting Overview seminar offered by the Office's Massachusetts Public Purchasing Official Program includes a presentation by the State Ethics Commission on the conflict of interest law. The DOE should also consider providing governance training to charter school trustees regarding their obligations as public agents to fulfill the duty of care and the duty of loyalty.

5. The DOE should ensure that the Board of Education has approved the terms of all educational services contracts requiring Board approval.

Each charter school submitting a draft contract for DOE review should be informed that it may not execute a final contract until the DOE has issued a letter of final approval.

The DOE should review each draft contract in a timely manner. If changes are warranted, the DOE should issue a written response to the school identifying all contract changes required as a condition of DOE approval and requiring the school to submit the amended contract to the DOE. The DOE should then review the amended contract and issue a letter of final approval only if the amended contract fully comports with the DOE's written response. The DOE should withhold quarterly payments from schools that fail to comply with this procedure; schools that deliberately execute educational services contracts containing provisions to which the DOE has objected should be subject to charter suspension or revocation.

6. **The DOE should develop and disseminate sample management contract provisions that protect the interests of charter school students, other public school students, and state taxpayers.**

The sample provisions should address key contracting issues affecting a school's ability to hold the contractor accountable for its educational and administrative performance. For example, the DOE should consider developing and disseminating sample contract provisions governing contractor performance evaluation methods and requirements, compensation, reporting requirements, and contract termination. The sample provisions should also include a provision requiring the management contractor to maintain school accounts in accordance with generally accepted accounting principles.

In view of the complexity of the intellectual property rights issue, the DOE should consider obtaining the services of an intellectual property attorney to develop sample contract language regarding development and licensing rights to intellectual property developed with charter school funds. To further the purposes of the charter school law, the DOE should require charter schools to incorporate into their management contracts a provision requiring that any educational curricula and other intellectual property developed by charter schools with public funds be made available at no charge to any Massachusetts public school, notwithstanding any other licensing provisions of the contract.

7. **The DOE should contract for and disseminate prototype accounting manuals for larger and smaller charter schools.**

No publicly funded organization delivering services to the public should operate for extended periods of time without an accounting manual defining the organization's financial systems and controls. As this report has shown, some charter schools still lacked accounting manuals several years after beginning operations. By contracting with a qualified certified public accounting firm to develop two prototype accounting manuals – one designed for larger charter schools, the other for smaller charter schools – the DOE would provide charter schools with a valuable and cost-effective management tool. A prototype accounting manual that could be adapted to suit each school's requirements would save administrative resources for newly chartered schools – and those schools that have not yet developed accounting manuals – that would otherwise be obligated to prepare or contract for preparation of their own accounting manuals. A prototype accounting manual would also strengthen the capacity of charter schools to operate efficiently, with appropriate internal control systems. The prototype accounting manual should incorporate the chart of accounts and other financial reporting forms recommended by the State Auditor, thereby increasing the DOE's capacity to provide meaningful financial oversight.

8. **The DOE should improve and standardize the annual independent audits conducted at charter schools.**

Although the independent audits commissioned by charter schools report essential information on charter schools' financial condition and internal controls, their usefulness to the DOE is diminished by variations in their quality and scope. To ensure that the DOE receives the financial information it needs to monitor the administrative performance of charter schools, the DOE should consult with the State Auditor's Office to develop a standard scope of services for charter school audits. In addition to requiring the financial statements to be audited in accordance with generally accepted government auditing standards, the scope of services should require the audit to report the following information:

- Assets and liabilities classified as current and noncurrent;
- All outstanding loan obligations, including the annual interest rate, repayment schedule, and purpose of each loan.
- All deferred contractual obligations, such as management fees and lease payments, and the annual interest rate charged on the unpaid balance for each deferred obligation.
- A written report or management letter, to be submitted to the DOE as well as the charter school's board of trustees, identifying any internal control weaknesses as well as any actions taken by the school to correct previously identified internal control deficiencies.

To ensure the quality, independence, and cost-effectiveness of the audits, the DOE should select the independent auditors to be hired by charter schools by conducting a competitive selection process on the basis of qualifications and price. The DOE should then either assign an independent auditor to each school or provide each school with a list of prequalified auditors from which to select an auditor.

9. The DOE should devote the necessary additional resources to ensure effective, proactive charter school oversight.

The foregoing recommendations call for the DOE to expand its oversight of charter school operations, a measure that will require the addition of new staff resources with the requisite financial and administrative expertise. In the view of the Inspector General, these additional resources would represent a sound financial investment in the future of the charter school initiative in Massachusetts.

Appendix A: The DOE's Response

The Commonwealth of Massachusetts
Department of Education

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David P. Driscoll
Commissioner of Education

RECEIVED
OCT 12 1999
OFFICE OF INSPECTOR GENERAL

October 12, 1999

Robert A. Cerasoli
Inspector General
Office of the Inspector General
One Ashburton Place, Room 1311
Boston, Massachusetts 02108

Dear Mr. Cerasoli:

Thank you for affording us the opportunity to read and comment on your Office's draft review of the Massachusetts charter school initiative. I want to also express my appreciation for the professional and cooperative manner in which your staff reviewed charter schools and the Department of Education's oversight of the initiative. Our dialogue with your staff and our review of this draft report have already provided us with most valuable information.

Below are both my general introductory comments as well as specific comments regarding each section of findings found in your report. I hope you will incorporate each of these comments into your final report.

General Comments

The state's charter school initiative started from square one in 1994. Because Massachusetts was one of the first five states in the country to start a charter school initiative, we have worked without benefit of any established model, locally or nationally. The development of this initiative, both under the former Executive Office of Education and now under the Department and Board of Education, has been marked by a steep learning curve and continual review, revision, and improvement of approaches.

We continue to revise and refine this initiative in a manner that provides to charter schools the freedoms associated with self-governance while at the same time holds them accountable for performance. It has been, and continues to be, a challenging task to construct clear methods for overseeing charter schools without stifling their performance. Oversight of charter schools, both of performance and of compliance with the many laws and regulations governing public schools, must be accomplished without getting in the way of a school's academic performance or undermining the self-governance of these public schools.

It is important for this report to highlight the fact that both the former Executive Office of Education and the Department of Education have strategically chosen to invest the bulk of limited resources for charter school oversight *on accountability for academic performance*. The overall message of your report is correct – that nothing is more important than ensuring that charter schools attain the maximum value for tax dollars spent. Because the ultimate measure of such value is the academic attainment of students and the quality of academic programs, state oversight must be targeted first and foremost on academic performance. Your report should highlight this point.

As your report indicates, several areas of charter school operation and associated state oversight merit further review and improvement. Given our own internal evaluations of the initiative, none of the findings in your report are new or surprising to us. We continue to revise and improve the methods by which we influence and oversee these areas. As an example of this attention, we have completely overhauled the process by which the Department reviews and supports the "start-up" of new charter schools, a process we have piloted with the five schools that opened this school year. This start-up review process focuses especially on governance, financial oversight, and legal and regulatory compliance. We are also in the process of expanding our charter school staff such that it will have greater capacity to execute oversight of charter schools. Additionally, the charter school staff is in the process of reviewing, revising and disseminating in a clear manner the statutory and regulatory guidance tools that have been developed since the start of the initiative.

Comments on Specific Sections of the Review

I have summarized below general responses to the six sections of the report that present review findings. Under separate cover, the Department's charter school staff is providing your office with a listing of factual errors and inaccuracies in the draft report.

Section II. Contracts with Private Management Contractors

Contractual relationships between charter schools and educational management companies are new to public schooling, both in Massachusetts and nationally. The management agreements you reviewed were some of the first in the country, and were designed without benefit of models specific to this new type of contract. I agree with your report that it is critical for the state to understand, monitor, and, where appropriate, set constraints on the design of these agreements. While contracts approved by the Executive Office of Education and this Department in previous years have been handled on a case-by-case basis, the Department is currently reviewing all existing contracts between charter schools and educational management companies and is developing a uniform protocol for review and approval of such contracts. The resulting protocol will be applied both to new contracts submitted for approval by future schools as well as the renewal of contracts submitted by existing schools. As your report emphasizes, how compensation to the contractor is structured in such management agreements will be a primary focus of our protocol. The Department's charter school staff contributed to the

national study of management agreements sponsored by the Charter Friends National Network, and will incorporate recommendations from that study into its protocol.

We would like to see the report emphasize that, like all charter schools, a charter school contracting with an educational management company is held accountable by the Department and Board of Education for the academic and organizational performance of its school *regardless of the general or specific terms of its contract with the management company*. The primary contract for a charter school is between the Board of Education and a charter school's board of trustees. Evaluation of a charter school's academic and organizational performance by the Department is ongoing and yields specific consequences for a charter school during, and at the end of, each five-year charter. It is by this primary contractual relationship between the Board of Education and a charter school that the state protects the interests of students and taxpayers. Conditions set by the Department regarding a school's academic and/or organizational performance supersede the terms of any management agreement between a charter school and an educational management company. As a result, the terms and execution of a management agreement, while clearly important to the operation and performance of a charter school, do not put at risk the public's interest regarding school performance.

It is also important to note, as does your report's footnote 29 on page 20, that management agreements designed subsequent to your review period demonstrate that charter schools negotiating such contracts are demanding clearer terms regarding academic performance standards. In our opinion, this represents a positive step forward in the evolution of relationships between charter schools and educational management companies and attests to the Department's improved oversight of these contracts. The report should highlight this point more prominently.

III. Conflict of Interest Issues

We agree with your report that compliance with M.G.L. Chapter 268A is of critical importance for charter schools. As part of the revision of legal and regulatory guidance being performed by the Department's charter school and legal staffs, attention to this issue is a high priority.

Your report addresses the issue of charter school trustees who also serve as directors of non-profit entities under contract with the same charter school. Acknowledging the challenges posed (and highlighted by your report) by the relationship between a charter school board of trustees and a non-profit entity, it is, nevertheless, critical that your report explain the unique origins of the three relationships you cite. In each of the cases you cite (Community Day Charter School, Lawrence Family Development Charter School, Neighborhood House Charter School), the non-profit entity under contract is itself the entity that initiated and supported the founding of the charter school and continues to provide critical support to the charter school. These three non-profit entities were the motivating forces behind each school's founding and are in large part responsible for each school's early and continued success.

Put simply, these three schools would not exist without these three non-profit entities. In each of the three cases, the interests of the non-profit organization are tightly and coherently tied to the academic performance of the school it supports. In each case, the link between the school and the non-profit entity is far more than the technical terms of the contractual relationship between the two. Such a relationship seems clearly different from a relationship in which a charter school, once founded, sets up a contractual relationship with an entity *with which it has no prior relationship*. While your report should in no way understate the legal obligations of trustees at these charter schools relative to M.G.L. Chapter 268A, it should provide comment on the unique nature of these three relationships and the benefit of the relationships to students.

IV. Loans

We ask that the report make note that, aside from a small federal start-up grant awarded during a school's first three years, charter schools are not provided with any start-up financial assistance. As a result, it is no surprise that charter schools obtain loans to overcome what would otherwise be insurmountable hurdles to opening and managing a public school during the first years of operation. With no start-up assistance and only minimal funding for facilities, the Commonwealth has left charter schools little choice but to assume debt.

Furthermore, your report should note that only recently have a very few banks begun to make conventional loans to charter schools. And still, despite promising early activity, most banks' inclination to lend to charter schools is at best cautious and usually nonexistent. Therefore, it is understandable that, given few or no viable alternatives, some charter schools have secured loans from educational management companies with which they contract for services.

Nevertheless, we agree that the Department of Education must continue to ensure that the risk of financial exposure to the Commonwealth is mitigated by monitoring and oversight of the financial obligations incurred by charter schools. Our charter school staff and legal staff are also addressing the question of taxpayer liability in the event that a charter school is incapable of meeting its financial obligations.

IV. Financial Management and Oversight

We agree that the lack of uniformity of audited financial statements from charter schools makes analysis, especially comparative analysis, of a school's financial viability difficult.

Beginning with Fiscal Year 2000 reporting, the Department has prescribed to charter schools the standard chart of accounts recommended by the State Auditor for charter school reporting. Additionally, the Department will follow that prescription with further and more detailed guidance to charter schools regarding their financial monitoring and reporting.

In regard to general fiscal oversight, fiscal management, and internal financial controls at charter schools, the Department's revised process for evaluating a new charter school's preparedness to open (which was conducted with the five schools that have opened this school year) incorporates a review of each school's internal financial controls as well as its policies and procedures for fiscal oversight and management. We intend to add to this work by providing further guidance to all charter schools, new and old, regarding sound fiscal oversight and control.

V. Procurement Procedures

As your report notes, while charter schools are not subject to M.G.L. c. 30B, the Department has advised charter schools (Technical Advisory 98-1) to follow sound business practices in the procurement of goods and services. Using the findings of your review as a resource, the Department will address the question of whether further guidance or follow-up monitoring of charter school procurement practices is appropriate.

VI. Facility leasing

The lack of adequate charter school facilities poses the greatest challenge to the success of this initiative. As you know, charter schools currently occupy facilities that range from good to inadequate. The report states that charter schools spent approximately $3 million on facilities in 1998, and that this expenditure may have been too high. It is important that the report also state the expenditure as a percentage of total revenues. If $3 million is an accurate figure, it amounts to 5.7% of the total revenue for the 24 charter schools open in 1998.

Finally, the Department will consider the report's recommendations regarding instituting controls over real property transactions, as well as the compliance of charter school charter schools with M.G.L. c. 7 s 40J.

Please contact me if you have any questions about my comments. My staff and I look forward to providing whatever additional assistance you may need as you prepare a final report. I would be grateful for a copy of the final report prior to its public release so that I may have sufficient time to review it before answering questions about it.

Again, I appreciate the hard work of your staff on this review, the manner in which they have conducted it, and the usefulness of the review's findings.

Sincerely,

David P. Driscoll
Commissioner of Education

Appendix B: Sources of Additional Information

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